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November 2019

TECHNICAL NOTE—BANK RESOLUTION AND CRISIS MANAGEMENT

This Technical Note on Bank Resolution and Crisis Management for Malta was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed in November 2018.

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November 6, 2019

TECHNICAL NOTE

BANK RESOLUTION AND CRISIS MANAGEMENT

Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared by an IMF Expert in the context of the Financial Sector Assessment Program (FSAP) in Malta during September 10–26, 2018, overseen by the Monetary and Capital Markets Department. The note contains technical analysis and detailed information underpinning the FSAP's findings and recommendations as of September 2018. Further information on the FSAP program is available at http://www.imf.org/external/np/fsap/fssa.aspx.

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Glossary

AMC	Asset Management Company
BRRD	European Union Bank Recovery and Resolution Directive (2014/59/EU)
BSU	Bank Supervision Unit
CBM	Central Bank of Malta
CP	Competent Person
DCS	Depositor Compensation Scheme
DSC	Domestic Standing Committee
EC	European Commission
ECB	European Central Bank
ELA	Emergency Liquidity Assistance
EU	European Union
FSAP	Financial Sector Assessment Program
HP-LSIs	High-Priority Less Significant Institution
LSI	Less Significant Institution
MFIN	Ministry for Finance
MFSA	Malta Financial Services Authority
MREL	Minimum Requirement for Own Funds and Eligible Liabilities
PRS	Preferred Resolution Strategy
P&A	Purchase and Assumption
RC	Resolution Committee
RU	Resolution Unit
SC	Supervisory Council (of the MFSA)
SI	Significant Institution
SRB	Single Resolution Board
SRF	Single Resolution Fund

EXECUTIVE SUMMARY

This Note analyzes laws, policies, and procedures for bank failure mitigation and resolution, and for preparation and management of a financial crisis in Malta. It addresses the supervision of bank recovery plans, early intervention when problems are identified, resolution planning, resolution funding, and deposit insurance. Until recently, Malta had no bank failures since the 1970's; two banks have failed in the past two years, and these experiences are assessed.

The Resolution Authority has a clear mandate, but operational independence could be strengthened. The Malta Financial Services Authority (MFSA) Board is designated as the Resolution Authority, but resolution decisions are taken by a statutory three-member Resolution Committee (RC), currently chaired by the Ministry of Finance (MINFIN). The composition of the RC should be strengthened to avoid the perception of a conflict of interest. Resolution functions are supported by a new Resolution Unit (RU), which has made good progress since its inception in early 2016 in staffing up and carrying out priority tasks. The RC and RU functions are sufficiently separated from the MFSA's supervisory functions, vested ultimately with the Supervisory Council (SC). The RU Head serves as secretariat to the Depositor Compensation Scheme (DCS) Management Committee and manages DCS functions. A Domestic Standing Committee (DSC) comprising the Central Bank of Malta´s (CBM) financial stability function and the MFSA's supervisory and resolution functions, along with a Permanent Secretary of the Ministry for Finance (MFIN), has a mandate to enhance crisis preparedness and to facilitate the management of an actual crisis. RU staffing levels seem inadequate for its current workload. A review of the adequacy of RU staffing levels should be undertaken and its resources increased.

Implementation of recovery planning requirements for banks remains a work in progress. The review of the most recent plans for less significant institutions (LSIs) remains to be completed. The issuance of guidance on simplified requirements will better enable integration of recovery planning into overall risk management in these institutions and reduce any unnecessary regulatory burden.

Written policies and procedures should be adopted on the application of early intervention powers. While legal triggers and power for early intervention in problem banks are adequate, the powers in relevant legislation overlap substantially. The MFSA should adopt written policies and procedures on when and how to use the powers.

Actions are needed to support the use of bank resolution powers, and to address weaknesses in the bank liquidation and insolvency framework. There is lack of clarity regarding the legal regime applicable to bank winding-up and insolvency, including as to the creditor hierarchy in liquidation. The uncertainties have ramifications for potential DCS recoveries in insolvency: for its potential role in creditor-led insolvency, for the potential to use DCS funds to finance the use of resolution tools, and for the application of shareholder and creditor safeguards in the context of the use of European Union (EU) Bank Recovery and Resolution Directive (BRRD) resolution tools. The MFIN should initiate a project to reform the legal framework for bank insolvency, taking into consideration the guidance in the international standard to adopt an administrative regime under which the resolution authority would have the power to implement the orderly closure and

liquidation of a failing bank. In the meantime, the DCS should clarify in writing its legal interpretation and policies under the current framework.

The MFSA should assess recent bank failure cases and seek to strengthen its supervisory and early intervention procedures, including to mitigate legal risk. A recent case of license withdrawal has been challenged by shareholders at the Court of Justice of the European Union and Malta Financial Services Tribunal. Although covered deposits have been paid out, the MFSA Board, acting as the supervisory authority, has elected not to put the bank into liquidation pending the court decision. The MFSA should assess recent bank failure cases with the goal, in part, to mitigate its legal risks, including those arising from use of a Competent Person (CP), a legal designation assigned to someone who controls the assets and manages the affairs of a bank for lengthy periods of time. Aiming at minimizing the overall costs, decisions on winding up an insolvent bank should be taken by the RC (pursuit of its statutory objectives of protecting depositors), the DCS, and other bank creditors.

Resolution planning by the Single Resolution Board (SRB) and the RU remains a work in progress. The plans are reasonably well advanced, though explicit planning for the resolution of the two significant life insurers associated with the two banks under the SRB's remit should be initiated. The RU is responsible for resolution plans for other banks. It has prioritized the High-Priority Less Significant Institutions (HP-LSIs); initial plans for two HP-LSIs are near completion and the third will be completed in early 2019. It is the intent to complete plans for all banks by end-2020. The RU should consider accelerating resolution planning, especially for weaker, smaller banks.

Impediments to implementation of the resolution tools are being identified and need to be addressed. Ensuring the availability of sufficient Minimum Requirement for Own Funds and Eligible Liabilities (MREL) is critical as the resolution regime mandates the bail-in of creditors. Issuing sufficient MREL, however, may prove challenging for banks considering the limited domestic professional investor market and issuance sizes that may be small for potential external investors. Ensuring adequate liquidity during and subsequent to resolution is another challenge.

Preparations need to be made for using the bridge institution resolution tool. While this tool is not considered a preferred option in existing resolution plans, it may well be required in case resolution strategies relying on other tools prove infeasible. Preparations should include specifying which entity will own a possible bridge institution, how the ownership function will be organized, how the institution's governance structures will be rapidly put in place in time of need, and how the bridge institution will be returned to the private sector in a timely manner.

The CBM has a well-developed emergency liquidity assistance (ELA) framework in place. The framework has been shared with the MFSA and the MFIN but not with the banks. The CBM should continue to document the legal and procedural requirements for perfecting liens on forms of collateral not used in regular monetary operations (but eligible under its ELA framework). Without prejudice to the CBM's sole discretion to decide on granting ELA, CBM should make its high-level policies and information and documentation requirements for collateral valuation, haircuts, and lien perfection known to potentially eligible banks.

The Minister of Finance has the power to borrow funds in the context of using resolution tools, including to finance the financial stabilization tools, subject to prior parliamentary approval. The MFIN should seek to clarify whether these provisions permit the creation of a borrowing facility that, as a last resort, can provide funding to the DCS and provide a backstop for the CBM's ELA, subject to prior approval by the European Commission Directorate-General for Competition and compliant with European Union (EU) state aid rules.

The MFSA and the MFIN should develop formal internal crisis management plans to complement and support the Interagency Crisis Management Framework. A Crisis Management Task Force serves as the DSC's permanent operational arm. At present, its significant task is to update the Interagency Crisis Management Framework, a contingency plan for dealing with a financial crisis. In conjunction with this work, the MFSA and the MFIN should ensure the adequacy of their own internal crisis management plans and that they complement and support the interagency framework. While the CBM's ELA Framework largely serves that purpose, the MFSA and the MFIN do not have well-documented plans in place.

Table 1 summarizes the most important recommendations made in this Note.

Table 1. Malta: Summary of Key Recommendations

Recommendation	Authority	Time*
Operational Capacities and Legal Protections		
1. Undertake a review of the adequacy of RU staffing levels and increase its resources accordingly. (¶16, 20)	MFSA	I
2. Extend legal protections to third parties and make explicit in law the provision to indemnify legal costs of MFSA staff and third parties. (¶17, 20-1)	MFSA	I
Recovery Planning and Early Intervention		
3. Issue guidance on the application of simplified obligations for recovery plans. (¶22, 32)	MFSA	NT
4. Adopt written policies and procedures on when and how to use early intervention powers, including to minimize use of CPs and Temporary Administrators. (¶27-29, 32)	MFSA	I
5. Assess recent bank failure experiences for lessons to strengthen supervisory and early intervention procedures, including to mitigate legal risk. (¶29, 32)	MFSA	NT
Insolvency and Special Resolution		
6. Update and streamline the legal framework for bank insolvency by developing an administrative bank insolvency regime. (¶34-38, 48, 84)	MFIN	I
7. Amend law to set out explicitly the availability of asset/liability transfer powers in insolvency. (¶38, 48)	MFIN	I
8. Shift responsibility for decisions on bank insolvency and liquidation from the MFSA's supervisory function to its resolution function. (¶37, 48)	MFSA	I
Resolution Planning, Strategies and Impediments, and Resolution Funding		
9. Accelerate resolution planning for any weak banks. (¶50, 52-61)	MFSA	I
10. Assign responsibility for development of formal resolution plans for *significant insurers* and initiate the work, ensuring integration with the plans for relevant banks. (¶51, 61)	MFS	I
11. Develop plans to establish a bridge institution. (¶56, 57, 61)	MFSA	NT
12. Undertake further work to document the legal and procedural requirements for perfecting liens on non-traditional forms of collateral. (¶67, 73)	CBM	I
13. Without prejudice to the CBM's sole discretion to decide on granting ELA, make high-level ELA policies for collateral valuation, haircuts, and information and documentation known to banks. (¶54, 69, 73)	CBM MFIN	I I
14. Put in place arrangements for a government guarantee of any unsecured ELA by the CBM subject to prior approval by the European Commission Directorate-General for Competition and in compliance with EU state aid rules. (¶71-73)		
Deposit Protection and Payout		
15. Ensure additional funding sources, ideally from commercial banks but, as a last resort, a borrowing facility from the government subject to possible EU state aid rules and obligations. (¶76, 86)	DCS MFSA	NT I
16. Adopt a policy to put a bank into liquidation when a deposit payout is made. (¶84, 86)		
Contingency Planning and Crisis Management		
17. Develop formal internal crisis management plans as a complement and input to the Interagency Crisis Management Framework. (¶92, 94)	MFSA, MFIN	NT

*I = Immediate (within 1 year); NT = near term (1–2 years); MT = medium term (3–5 years).

BACKGROUND

A. Scope of the Note[1]

1. This Technical Note analyzes the bank failure mitigation and resolution regime in Malta, as well as arrangements for preparing for and managing a financial crisis. It summarizes the findings of the FSAP mission undertaken during the period September 10–26, 2018. The Note addresses the supervision of recovery planning by banks, early intervention in banks by the authorities when problems are identified, resolution planning by the resolution authorities, the institutional and legal framework for bank resolution and financial safety nets, and the authorities' preparedness to deal with a potential system-wide crisis. It also considers recovery and resolution planning for *significant insurers* with links to banks. The assessment presented in this Note is based on an analysis of the legal framework and documentation relating to policies and procedures, and on discussions with and representations made by the authorities and the private sector. The Note does not represent an assessment of adherence to relevant international standards, especially the Key Attributes of Effective Resolution Regimes for Financial Institutions and the Core Principles for Effective Deposit Insurance Systems,[2] though those standards serve as a frame of reference for certain recommendations cited in this Note.

B. Financial Sector Landscape

2. Three banks in Malta are designated as SIs by the ECB[3,4]

- Bank of Valletta, the largest bank in the country, with 44 percent of total deposits, is 25 percent owned by the government, and it is sole shareholder of an asset management subsidiary and investment management subsidiary, as well as a minority shareholder in a local insurer[5] and a 50 percent owner of one of the two dominant life insurers in Malta.[6]

- HSBC Bank Malta, with a 21 percent share of total deposits, is an indirect subsidiary[7] of HSBC Bank Plc, based in the United Kingdom, and is sole shareholder of the other major life insurance subsidiary and of an asset management subsidiary.

[1] This note was prepared by David H. Scott, External Expert for the Monetary and Capital Markets Department. The review was conducted during the period of September 10–26, 2018, and considers the legal and regulatory framework in place and the supervisory practices employed at the time.

[2] These standards are established by the Financial Stability Board (Key Attributes) and Basel Committee on Banking Supervision and International Association of Deposit Insurers (core principles).

[3] At a minimum, the ECB designates the three largest banks by assets in each jurisdiction as an SI.

[4] Information about deposit market share refers to total deposits in banks, excluding foreign branches.

[5] The majority shareholder is the global insurance group, MAPFRE, based in Spain.

[6] MAPFRE MSV Life. The insurer also is controlled by the Spanish MAPFRE group and is reportedly consolidated into its books in Spain. The Bank of Valletta serves as the life insurer's distribution outlet.

[7] Via intermediate companies.

- MeDirect Bank is owned by a Malta registered holding company that is ultimately owned by a hedge fund based in the United Kingdom. MeDirect is a largely internet-based bank[8] with an 8 percent market share of total deposits in Malta. The bank owns another internet-based bank in Belgium of comparable size.

3. Other banks are also of domestic importance. Among the six banks classified as *core banks* by the CBM, in that they mainly service the domestic market, are BNF Bank, Lombard Bank, and APS Bank. BNF Bank is owned by Qatari investors. Lombard Bank is 49 percent owned by the National Development and Social Fund. APS Bank is majority-owned by the Archdiocese of Malta and Gozo.[9] Five other banks serving the domestic market are classified by the CBM as *noncore*. Some 80 percent of the assets of these five are concentrated in FIM Bank and Sparkasse Bank. FIM Bank, Malta's fourth largest bank, is owned by investors in Kuwait and Bahrain. Sparkasse Bank is part of the Austrian group of the same name. Three of the banks are designated as HP-LSIs.

4. There are 14 other banks operating in the market which do business largely with non-residents and are classified as *international banks* by the CBM. These include two branches of Turkish banks with balance sheets comparable in size to that of the Bank of Valletta.[10] The others are small banks, including a branch and a subsidiary of EU banks. The MFSA has intervened into the operations of two banks previously classified as *international banks*, Nemea Bank and Pilatus Bank. In both cases, the MFSA requested the ECB to withdraw the banks' license.[11] The deposits of the banks are eligible for Malta DCS coverage, whereas the deposits of the two Turkish branches are not.[12]

5. The two large life insurers are potentially systemic. Together, HSBC Life and MSV Life (Bank of Valletta) have a 95 percent share of the life insurance market in Malta.[13] Both are fully dependent on their associated banks to distribute their products.

C. Legal Framework

6. Multiple laws and regulations govern the management of problem and failing banks in Malta. The legal framework was amended and enhanced with the transposition of the EU Bank Recovery and Resolution Directive (BRRD) and Deposit Guarantee Scheme Directive in 2015. The BRRD was transposed by means of the issuance of the Recovery and Resolution Regulations under the MFSA Act, along with relevant amendments to the MFSA Act itself. The Deposit Guarantee Scheme Directive was transposed by means of the DCS Regulations under the MFSA Act. The legal framework relevant for this Note also includes the Banking Act, the Central Bank of Malta Act, the

[8] It does not operate branches.

[9] The other three core banks are the SIs.

[10] The branches reportedly serve as a booking center for tax minimization purposes for a relatively small number of deposit clients referred by bank head offices.

[11] See Part D (Recent Crisis Experience) below.

[12] The third branch is that of a Dutch bank controlled by a Turkish firm. The branch is covered by the Dutch DGS.

[13] The authorities have not identified any insurers or other non-banks as systemic. In this Note, potentially systemic insurers will be referred to as *significant insurers*.

Companies Act, the Controlled Companies Act, and the Bank Reorganization and Winding-up Regulations issued under the Banking Act.

7. The Insurance Business Act provides the legal framework of managing failing insurers. The Act also addresses early intervention measures to deal with problems insurers.

D. Recent Crisis Experience

8. There have been two recent instances of bank failure. These are the first two bank failures in Malta since the 1970s and were managed by the Bank Supervision Unit (BSU), SC, and the MFSA Board in its supervisory capacity. The legal framework underlying these cases, and the legal, policy, and procedural issues they give rise to, are explained and discussed in subsequent sections of this Note. These brief descriptions of the two cases are drawn from information in the public domain.

9. The MFSA appointed a CP to Nemea Bank in April 2016 and its license was withdrawn by the ECB in March 2017. The appointment of the CP followed a joint MFSA/ECB onsite inspection.

- On April 20, 2016, subsequent to conducting an analysis to determine if it would be in the public interest to put Nemea Bank into resolution, the RC decided that normal insolvency proceedings were the best course of action. The MFSA as competent authority was informed accordingly.

- On April 27, 2016, the MFSA appointed a CP to take charge of the bank's assets and assume control of its business. It also announced that the bank had been issued a Directive regarding accepting new deposits and deposit withdrawals. The public notice cited a number of serious regulatory shortcomings that were identified during the inspection. By way of separate public notice on the same day, the MFSA restricted depositor withdrawals to €250 per day and prohibited acceptance of new deposits.

- On July 18, 2016, the MFSA increased the daily withdrawal limit to €2,500 per day and maintained the prohibition on accepting new deposits. This easing was subject to the condition that the present maturities of deposits are maintained and that no term deposits be withdrawn before their stated maturity dates. The MFSA also confirmed ongoing discussions with shareholders on ensuring necessary actions to address regulatory shortcomings.

- On January 20, 2017, the MFSA issued a public notice stating that it had asked the ECB to initiate the process to withdraw the bank's license on the grounds of lack of tangible progress in fulfilling regulatory requirements. The notice stated that the MFSA had issued a Directive to the bank to block further deposit withdrawals. After following its internal procedures, the ECB withdrew the license on March 23, 2017.

- On March 30, 2017, the MFSA triggered a deposit payout by the DCS.

- At time of writing (October 2018), the CP remains in place and the bank has not been placed in liquidation pending an appeal of the ECB's decision to the Court of Justice of the European Union by bank shareholders.

10. A CP was appointed to Pilatus Bank in March 2018 and a request to withdraw its license submitted to the ECB in June 2018.

- On March 20, 2018, the bank's ultimate beneficial owner, chairman, and chief executive officer (CEO) was indicted in the United States.[14]

- On March 21, 2018, the MFSA issued public notices stating that it had issued a Directive to the bank to cease all transactions, and that it had removed the bank's CEO and suspended his voting rights.

- On March 22, 2018, the MFSA appointed a CP to take charge of the bank's assets and assume control of its business.

- On May 3, 2018, the RC, following discussions with the MFSA as competent authority, made a Public Interest Assessment to determine the preferred strategy for Pilatus Bank. The decision of the RC was that normal insolvency proceedings were the best strategy as they would meet the resolution objectives at least to the same extent as a resolution under the BRRD. This decision was communicated to the MFSA as competent authority.

- On June 30, 2018, the MFSA submitted a draft decision to the ECB requesting withdrawal of the bank's license on the grounds of unsuitability of the ultimate beneficial owner and breach of regulatory liquidity coverage.[15]

- At time of writing (October 2018), the ECB had not yet decided on this request.[16] Should the license be withdrawn, it is not anticipated there will be any cost to the DCS. The bank's covered deposits, which represent only a small proportion of total deposits, are fully matched by a contingency contribution in favor of the DCS by Pilatus Bank, held in cash at the CBM. This arrangement was a condition of the bank's license (granted in January 2014).

[14] One and the same person. The U.S. indictment included charges of participation in a scheme to illegally funnel US$115 million in payments from Venezuela to Iranian individuals, evading U.S. economic sanctions against Iran. The indictment does not mention Pilatus Bank nor Malta.

[15] See press release, "MFSA recommends to the ECB, the Withdrawal of Pilatus Bank's License."

[16] ECB's Governing Council decided to withdraw the authorization of Pilatus Bank with effect from November 5, 2018.

STRENGTHENING THE FRAMEWORK

A. Institutional Framework, Operational Capabilities, and Legal Protections

11. Like other members of the Banking Union, the ECB and the SRB play a significant role in bank supervision and resolution in Malta. The roles of the ECB under the Single Supervision Mechanism and the SRB under the Single Resolution Mechanism mainly fall into three categories: (i) the exercise of direct supervision powers by the ECB and resolution planning and resolution decision-making powers by the SRB over the institutions under their respective remits;[17] (ii) the oversight of the National Competent (Supervisory) Authorities by the ECB and National Resolution Authorities by the SRB; and (iii) if deemed necessary to ensure consistent application of supervisory and resolution standards, the direct exercise by the ECB and SRB of their respective powers for institutions under the purview of the National Competent Authorities and National Regulatory Authorities.

12. The domestic financial authorities nonetheless continue to play critical roles. The domestic authorities relevant to this Note are the MFSA, the CBM, and the MFIN. The MFSA is both Malta's National Competent Authority and National Resolution Authority. As the national resolution authority it is responsible for the resolution planning arrangements, including the Malta component of the Single Resolution Fund (SRF).[18] The DCS is responsible for its funding arrangements.[19] The MFSA contributes substantially to the work of the ECB and the SRB with respect to Maltese banks by participating in ECB Joint Supervisory Teams and SRB Internal Resolution Teams, and is responsible for all banks/groups not under the remit of those two institutions. The MFSA as the national resolution authority also is responsible for conducting a Public Interest Assessment to determine whether a bank goes into normal insolvency proceedings or resolution; for executing all resolution actions, including those decided upon by the SRB; and for participating in SRB governance by means of its representation in SRB Extended Executive Sessions and Plenary Sessions.

13. The MFSA Board of Governors serves as the Resolution Authority for banks but does not take resolution decisions, which under the MFSA Act are taken by the RC. The RC has all the powers assigned to a Resolution Authority under the BRRD and is supported by the RU (see paragraph 14). The RC is composed of three persons, only one of which appointed by the MFSA, with the other two appointed by the CBM and the MFIN (the latter is currently the chair).[20] Members are appointed for three-year terms and can be reappointed once. The presence of MFIN and the

[17] The SRB is the resolution authority for (i) SIs and banks in relation to which the ECB has decided to exercise directly all its relevant supervisory powers; and (ii) other cross-border groups, where both the parent and at least one subsidiary bank are established in two different participating member states of the EU Banking Union.

[18] See details in Part E of this Section of the Note.

[19] See details in Part F of this Section of the Note.

[20] The RC chooses its chair from among its members. The current chair is the MFIN representative, who is Director-General of the Treasury. The CBM representative is a former CBM governor, and the MFSA representative is a lawyer in private practice.

relatively short term of the RC member' mandate does not support the perception of operational independence from political influence. [21] The operational independence of the *de facto* Resolution Authority should be strengthened by changing the RC´s composition to all independent members[22] and prescribing terms for its members that are longer than the national election cycle. The RC should only consult with the MFIN for decisions entailing the use of public funds (or potential use of public funds). The RC and RU functions are sufficiently separated from MFSA's supervisory functions, vested ultimately with the SC. The RC reports directly to the MFSA Board (acting as the Resolution Authority) and takes resolution decisions based upon the recommendations of the RU. It communicates resolution decisions to the Board/RA and implements those decisions. It must notify the Minister of Finance regarding its resolution decisions (ex post) and must seek the minister's written approval prior to taking any decisions that may have a direct fiscal impact or which have systemic implications. The RC administers the Malta component of the SRF, issued the Recovery and Resolution Regulations, which transposed the BRRD, and may issue binding and timebound directives to individuals. While the law does not formally designate it as such, the MFSA Board also is the authority for the resolution of insurers.

14. The RU carries out the functions assigned to it by the RC. The RU is responsible for resolution planning, undertaking resolvability assessments, and executing resolution actions as determined by the SRB or RC. The RU may also assess whether an institution is failing or is likely to fail and make a recommendation to the RC.[23] The RU is led by the RU Head and currently has nine staff and two additional as yet unfilled positions.[24] The unit's budget is proposed by the RU Head, and, as with all MFSA units' budgets, is discussed with the Chief Operations Officer and ultimately approved by the MFSA Board. The RU Head represents the MFSA in SRB governing bodies. The RU may draw upon other MFSA staff and contract with external consultants in time of need. Currently, there is no framework specifically governing the resolution of insurers, and the RU plays no direct role in resolution work related to insurers. However, it does engage with the MFSA's Insurance and Pensions Supervision Unit (IPSU) regarding consultation papers, etc., issued at European level on the subject.[25]

15. In summary, at present the Board/RA serves mainly as a policy-making body, the RC as the resolution decision maker, and the RU as the operational body undertaking planning and analysis, making recommendations on decisions, and executing decisions. The RU Director (and staff) meet periodically with the RC to report on activities and developments. In 2017, five such meetings were held and in 2016 six meetings were held. SI resolution plans and matters associated with the two recent bank failures have been the primary focus. The RU prepares a quarterly report

[21] See Key Attribute 2.5.

[22] I.e. no active bankers and no government officials.

[23] The SC may also make such an assessment.

[24] A senior manager, four analysts, two lawyers, and two clerical/administrative staff. Two additional analysts are envisaged to be appointed by end-2018.

[25] Resolution of problem insurers currently is the responsibility of the Insurance and Pensions Supervision Unit.

on its activities, which is endorsed by the RC and provided to the Board (acting as the Resolution Authority). The RU also makes periodic reports to the Domestic Standing Committee.[26]

16. Approved RU staffing levels appear inadequate. The unit's work program currently includes significant engagement with the SRB and its Internal Resolution Teams to formulate resolution strategies and develop resolution implementation plans for SIs, assessing and deciding on resolution strategies, and implementation plans for HP-LSIs, and for weak LSIs. It also contributes to SRB policy development and participates in SRB governing bodies, prepares Handbooks of policies and procedures for implementing resolution tools, and participates in Crisis Management Task Force efforts to develop an interagency crisis preparedness framework. This Note makes recommendations regarding a number of matters that imply additional work for the RU, including (i) supporting decision making regarding bank insolvency cases; (ii) undertaking legal analysis to support a revision of the bank insolvency regime; (iii) the development of additional written policies and procedures; and (iv) accelerating resolution planning.[27] Furthermore, commencing work on resolution plans for systemic insurers will require additional qualified staff. A review of the adequacy of RU staffing levels should be commissioned by the MFSA Board and its resources increased accordingly.

17. Legal protections are afforded MFSA staff but not contracted third parties such as CPs appointed by the MFSA as part of an intervention in a bank. The MFSA Act provides the Board, management, and staff with adequate legal protections.[28] The Act does not provide for indemnification of legal expenses incurred by staff when defending themselves and does not cover third parties. Indemnification of staff legal expenses, however, is outlined in the staff handbook, which forms part of the contractual relationship between the MFSA and its employees. Reportedly, it is the intent to consolidate various sectoral legislative provisions extending legal protections to MFSA staff into a single provision in the MFSA Act. As part of this effort, the authorities should extend legal protections to third parties, such as CPs, and to make explicit the provision to indemnify legal costs. Operational arrangements to make legal protection effective should also be introduced, covering such issues as the choice and (timing of) payment of legal representation and liability, and legal aide insurance covering realistic monetary amounts.

[26] See Part G of this Section of the Note for more on the DSC.

[27] Furthermore, commencing work on resolution plans for *significant insurers* will require qualified staff.

[28] Art. 29 provides that MFSA employees shall "not be liable in damages for anything done or omitted to be done in the discharge or purported discharge of any function under this Act or any other Act administered by the Authority, or otherwise in the exercise of their official duties, unless the act or omission is shown to have been done or omitted to be done, as the case may be, in bad faith…."

18. The DCS is a "paybox" within the MFSA. The DCS is administered by a Management Committee comprised of seven members (who also make up the Investor Compensation Scheme).[29] The administration of the DCS vests with a secretariat housed within the MFSA, including a senior manager, lawyer, statistician, and two analysts. The RU Head serves as the secretary to the Management Committee. The members of the Management Committee are legally protected in the same manner as the members of the RC and staff of the RU by virtue of provisions of the Investor Compensation Scheme Regulations.[30] While operationally independent, the DCS is exposed to potential inaction by the MFSA Board in its supervisory capacity, a matter addressed in Part F of this Section of the Note.

19. RU staff are appropriately engaged in existing resolution colleges. Staff participate with the SRB in the Bank of England Crisis Management Group (resolution college) for the HSBC group.[31] The RU communicates its views through the SRB. The RU has only limited involvement in the resolution college for a euro area bank, which has a small subsidiary in Malta that is classified as an LSI and is deemed not to have critical functions in Malta. The participation in the resolution college mainly involves collecting certain data that is forwarded to the college and providing comments on draft resolution plan.

20. Summary of Recommendations:

- Strengthen the RC´s independence by changing its composition to all independent members and prescribing terms for its members that are longer than the national election cycle;
- Amend law such that the requirement for the Minister's prior written approval for decisions that have systemic impact is limited to those which have potential fiscal implications;
- Undertake a review of the adequacy of RU staffing levels and increase its resources accordingly;
- Extend legal protections to third parties and make explicit in law the provision to indemnify legal costs.
- Introduce operational arrangements to make legal protection effective, covering such issues as the choice and (timing of) payment of legal representation and liability, and legal aid insurance covering realistic monetary amounts.

[29] The chair is appointed by the MFSA Board and presently is a CBM manager. Other members include: an officer from the CA; a nominee of an association representing persons holding a license under the Investment Services Act (presently an employee of Bank of Valletta); a nominee of an association representing banks which contribute to the DCS (an employee of the Bankers Association); a person nominated jointly by the associations representing persons holding a license and contributing to the DCS or ICS (a lawyer in private practice); an officer from the CBM (other than the chair); a person to represent the point of view of consumers (an employee of the Malta Competition and Consumer Affairs Authority).

[30] Regulation 31.

[31] MFSA's Bank Supervision Unit and the DCS are also are invited to attend.

B. Recovery Planning and Early Intervention

21. As noted, the supervision of Malta banks, including recovery planning and early intervention, is a joint exercise between the ECB and the MFSA. The ECB-led Joint Supervisory Teams are responsible for supervision of SIs, whereas BSU staff supervise HP-LSIs and LSIs. The Joint Supervisory Teams are led by ECB coordinators, with a sub-coordinator and staff from MFSA. In the assessment of SI recovery plans the joint teams are supported by ECB experts from different departments.[32]

Recovery Planning

22. The MFSA began to implement recovery planning requirements in 2015 but has yet to issue guidance on "simplified obligations." The MFSA provided guidance to banks in September 2015, essentially requiring that they follow the various European Banking Authority guidance that had been issued at that time in final or draft form. Provisional recovery plans were required from all banks by end-2015. Guidance on so-called "simplified obligations," essentially allowing simpler and smaller banks to submit streamlined plans, has yet to be issued by the MFSA, though it continues to work to identify banks that would qualify based on European Bank Authority guidance. Discussions with market participants indicate that while often initially perceived as a regulatory compliance exercise, banks are increasingly recognizing the value of recovery planning in their overall risk management and strategic planning. The MFSA should issue guidance on the application of simplified obligations to facilitate integration of bank risk management and to reduce unnecessary regulatory burden on smaller banks.

23. Recovery plans for SIs are well advanced but remain a work in progress. As noted, the ECB's Joint Supervisory Teams lead this effort with support from BSU staff. The joint team's most recent feedback letters to banks identify specific matters requiring improvement. Recovery plans for SIs are shared with the SRB and the RU, which collectively identify actions in the plan that could adversely affect the resolvability of the institution, and make any concerns known to the ECB. Concerns expressed to date reportedly have mainly related to the implications of selling or encumbering securities portfolios in recovery that may impair the ability to maintain liquidity in resolution.

24. All HP-LSIs and LSIs have now submitted second round recovery plans to the BSU. The plans of all HP-LSIs and most LSIs were deemed as requiring improvement in terms of the assessment criteria set out by the ECB.[33] Special attention is being given to the plans of HP-LSIs and problem banks. Plans of other banks are still to be reviewed. The RU conducts reviews the recovery plans to comment on issues that may have an impact on the resolution scheme of the LSI. So far, no major issues have yet been identified, in part because resolution planning is not advanced for many

[32] The Crisis Management Division within the European Central Bank's Directorate General Micro-Prudential Supervision IV group.

[33] The criteria address the plans' (i) completeness, (ii) quality (particularly in terms of the range and detail of identified recovery options), and (iii) credibility (especially the likelihood of being able to implement identified recovery options successfully).

of these banks.[34] The BSU and the RU are discussing more formal procedures providing for review of LSI recovery plans by the RU, and this should be brought to conclusion. Eventually detailed cooperative arrangements between the BSU and the RU to facilitate a well-staged transition to potential failure resolution should be put in place.

25. Recovery planning by significant insurers is addressed as part of the normal supervisory process. Feedback provided by the Insurance and Pensions Supervision Unit on the two *significant insurers'* internal Own Risk and Solvency Assessment appropriately addresses recovery (and resolution) planning by these firms.[35] There is scope for further collaboration between the BSU and its insurance and pensions counterpart in forming an integrated view of recovery planning by the insurers and the banks to which each is associated.

Early Intervention

26. Amendments to the Banking Act and the adoption of the Recovery and Resolution Regulations strengthened the early intervention framework in Malta. The EU's Capital Requirements Directive IV includes measures to address banking problems at an early stage. These measures were incorporated into Malta's Banking Act. In addition, the BRRD introduced a common set of early intervention measures that were transposed via the Recovery and Resolution Regulations. The ECB and the MFSA are responsible for the application of early intervention measures to SIs and LSIs respectively. While the ECB has the power to decide to exercise direct supervision of an LSI when it deems it necessary to ensure consistent application of high supervisory standards—it has not done so in Malta. Any use of intervention powers by the MFSA must be communicated promptly to the ECB.

27. The legal triggers for taking early intervention measures and the measures themselves are adequate. The Banking Act allows the MFSA to restrict or withdraw[36] a bank's license under a wide range of circumstances.[37] The Recovery and Resolution Regulations similarly allow the MFSA to act whenever there is an infringement of a wide range of prudential requirements or when a bank's financial condition is deteriorating.[38] Early intervention measures under the Banking Act, the MFSA Act, and the Recovery and Resolution Regulations are broad. In the case of the regulations, the MFSA has the explicit power to require a bank to implement recovery options set out in its recovery plan. Under the Banking Act, the MFSA has broad power to issue a Directive to a bank for any reason it deems appropriate,[39] and can appoint a CP who can be tasked to (i) advise the bank on the proper conduct of business; (ii) take charge of some or all of its assets; or (iii) assume control of the

[34] See Part D of this Section of the Note.

[35] See also the Technical Note on *Regulation and Supervision of Insurance and Securities Sectors*, produced under this FSAP.

[36] Under the Single Supervision Mechanism Regulation, license withdrawal for both SIs and LSIs is a decision that can only be taken by the ECB in consultation with or upon proposal of the national authorities.

[37] Banking Act Art. 9 (2).

[38] Regulation 27.

[39] Banking Act Art. 4B.

bank to carry on its business (including that of the general meeting of shareholders) or "to carry out such other function or functions in respect of such business, or part thereof," as the MFSA may direct.[40] Under the Recovery and Resolution Regulations, the MFSA can appoint a Temporary Administrator with the power, *inter alia*, to assume the responsibilities of the Board and to convene a meeting of shareholders. This may include managing a bank's business in order to preserve or restore its financial position and taking measures to restore its sound and prudent management.

28. The powers in the Banking Act, the MFSA Act, and in the Recovery and Resolution Regulations overlap substantially and are complementary. The MFSA does not have a written policy as to under what circumstances and how to apply these respective powers. As described in the Introduction of this Note, it used its powers under the Banking Act to appoint CPs to Nemea Bank and Pilatus Bank,[41] and to issue Directives to the banks restricting their business. It has not, to date, used its powers under the Recovery and Resolution Regulations for early intervention or to appoint a Temporary Administrator. There may be circumstances where use of the regulations provides alternatives not available under the Banking Act.[42] The MFSA should adopt written policies on when and how to use its arsenal of powers. Having a written policy in place will provide clarity to BSU and RU staffs and could prove useful in the case of challenges by affected parties.

29. There have been lengthy periods of time between an MFSA announcement of serious regulatory concerns regarding a bank, the announcement that it has requested the ECB to initiate the process to withdraw the bank's license, and the ECB's decision to withdraw the license. In the case of Nemea Bank, serious concerns were announced on April 27, 2016,[43] the request to withdraw the license announced on January 27, 2017 (fully nine months later), and the license withdrawn on March 23, 2017. To mitigate the likely run on the bank during this period, the MFSA is forced to impose deposit withdrawal restrictions or freezes. Further, to prevent mis-appropriation of assets or any other imprudent activity, the MFSA is forced to appoint a CP, either to take charge of the bank's assets and assume control of its business,[44] or at least to advise the bank's manager,[45] which, in conjunction with Directives issued to the bank, can serve to control its activities. MFSA's decisions in this regard are subject to the approval of and thus direction by the ECB. The lengthy periods of time are attributed largely to the need to give the managers, directors, and shareholders of the bank ample opportunity to remedy the supervisory concerns (e.g., to raise additional capital), and to document the analysis, actions, and decisions of the MFSA and the ECB. This is deemed necessary to guard against possible legal challenge by the directors and/or shareholders to possible license withdrawal by the ECB. Yet the appointment of a CP gives rise to its

[40] Banking Act Art. 29 (1) (b), (c) and (d).

[41] In the case of Nemea Bank, a manager in a local office of an international accounting and auditing firm was appointed, and in Pilatus Bank a foreign expert was appointed.

[42] For example, under Recovery and Resolution Regulations 29 (2), the RC has the power to require a bank to contact potential purchasers.

[43] The announcement was required in the context of imposing deposit withdrawal restrictions and appointing a CP.

[44] Banking Act Art. 29 (1) (c) and (d) powers.

[45] Banking Act Art. 29 (1) (b) powers.

own exposure to legal challenge[46] and potential liability to the MFSA. To limit its exposure, the MFSA should adopt policies and procedures to minimize the use of a CP[47] to the greatest extent possible. The MFSA, perhaps with support from the ECB, should assess its recent experiences for lessons on ways to strengthen its supervisory and early intervention procedures with the goal, in part, to mitigate the need to appoint a CP for lengthy periods of time. Ideally the CP, if required, would be appointed only at the time of an MFSA request to the ECB to withdraw the license—and under Art. 29 (1) (b) powers, which may involve less legal risk.

30. Early intervention regime for insurers is set out in the Insurance Business Act. The Act gives the MFSA the power, where it is satisfied that sufficiently serious circumstances exist, to require an insurer to take any steps the MFSA may deem necessary to rectify or remedy a situation.[48] The Act also gives the MFSA the power to give by notice in writing such directives as it may deem appropriate in the circumstances.[49]

31. Early intervention powers are subject to challenge. Any person who is aggrieved by a decision or action may appeal to the Financial Services Tribunal within 30 days.[50] Appellants might argue that the MFSA wrongly applied the provisions of law or regulation, or that the decision/action constitutes an abuse of discretion or is manifestly unfair. In addition, an aggrieved person has the right to appeal a question of law within 20 days of a decision of the tribunal to the Court of Appeal (Civil, Inferior Jurisdiction). However, an appeal does not suspend the operation of a decision or action.

32. Summary of recommendations:

- Issue guidance on the application of "simplified obligations" for recovery plans;
- The BSU and the RU should adopt more formal procedures providing for RU review of the recovery plans of LSIs;
- Pursue further collaboration between the BSU and the Insurance and Pensions Supervision Unit in forming an integrated view of recovery planning by *significant insurers* and their tied banks;
- Adopt written policies and procedures on when and how to use early intervention powers, including to minimize use of a CP by the competent authority or a Temporary Administrator by the RC; and

[46] Particularly under Banking Act Art. 29 (1) (c) and (d).

[47] E.g., under Banking Act Art. 29 (1) (c) and (d).

[48] Art. 28(1) (a).

[49] Banking Act Art. 31A.

[50] Banking Act Art. 10 and MFSA Act Art. 21.

- Assess recent experiences for lessons to strengthen supervisory and early intervention procedures, including to reduce the period of time a CP needs to be utilized.

C. Insolvency and Special Resolution

33. Multiple laws and regulations may govern the failure of banks. Besides the Companies Act, which may apply, bank failure is addressed in the Banking Act, the Controlled Companies (Procedure for Liquidation) Act, the Credit Institutions (Bank) Reorganization and Winding Up Regulations, and the Recovery and Resolution Regulations.[51] This part of the Note assesses the legal regimes for banks that are non-systemic and for those that are potentially systemic in failure.

Insolvency Proceedings

34. There is lack of clarity regarding the legal regime applicable to winding-up and insolvency proceedings for banks whose failure would not give rise to systemic implications. The interplay between the laws and regulations cited above, all of which could potentially apply, is subject to varying interpretation. Discussions with the authorities and private sector make clear that there is no consensus on the best means to apply the current legal framework. This extends to uncertainty as to what credit hierarchy would apply, as the provisions of different acts vary in this respect.[52,53] The MFIN should initiate, as a high priority, a project to update and streamline the legal framework for insolvency proceedings for banks to eliminate inconsistencies, clarify uncertainties and introduce an administrative regime for the orderly closure and liquidation of a failing bank.

- The *Companies Act* has three insolvency and liquidation regimes that could be applied to banks: (i) a court-overseen regime that could be used for a solvent bank; (ii) a court-overseen regime that could be used for an insolvent bank; and (iii) a court-led regime that could be used for either a solvent or an insolvent bank.[54] There is uncertainty regarding what creditor hierarchy would apply in bank insolvency, as the provisions of different acts vary in this respect, which may result in uncertainty as to the ranking of the DCS in subrogation of covered depositor claims.

- The *Bank Reorganization and Winding-Up Regulations* were adopted in the 1970s and modify certain provisions of the Companies Act, but their use is apparently dependent on obtaining additional capital.

[51] The resolution of insurers is governed by the Insurance Business Act.

[52] The implications of this lack of clarity regarding the creditor hierarchy are cited below in this Part of the Note addressing the special resolution regime, and in Part F of this Section of the Note addressing the ranking of DCS claims in subrogation of covered deposits.

[53] On December 21, 2018, Article 29A of the Banking Act was amended to harmonize the provisions of this Article with the creditor hierarchy under Article 108 of the BRRD. As the amendment took place after the conclusion of the FSAP mission, it was not reviewed by the mission team.

[54] The MFSA would typically request the ECB to withdraw a bank's license well before it is "balance sheet insolvent." Once winding up or liquidation commences, a bank could be discovered to be insolvent. The Companies Act envisions this type of circumstance, while the other potentially relevant laws and regulations apparently do not.

- The *Banking Act* provides the MFSA the power to appoint a liquidator but sets out no procedures for liquidation.

- The *Controlled Companies Act* dates from the 1970s and was tailored to the circumstances of a particular failing bank, but apparently only applies to insolvent banks and is deemed by some as not usable.[55]

35. As discussed earlier, the ECB's decision to withdraw a license is subject to challenge and potential reversal. In the case of HPLSIs and LSIs, the MFSA makes a formal written request to the ECB to withdraw the license along with the justification for doing so. The ECB takes the decision at the level of the Supervisory Board and then affords the shareholders the opportunity to be heard. If there is no change in the Supervisory Board's decision it is sent to the ECB Governing Council for no objection. The shareholders can challenge a decision to withdraw the license to the ECB's Administrative Board of Review for up to one month after the decision. The board must decide no later than two months from receipt of the challenge. If it affirms the Supervisory Board's decision, the shareholders can take their challenge to the Court of Justice of the European Union. There is no time limit on when the court must render a verdict.

36. These rights to appeal have had adverse implications for the efficient resolution of the Nemea Bank failure. As noted, Nemea shareholders appealed the decision to withdraw the license to the Court of Justice of the European Union. As there is no legal requirement whereby license withdrawal triggers liquidation, and although its license has been withdrawn and covered deposits paid out, the MFSA Board, acting as the supervisory authority, took a decision to not place Nemea Bank into liquidation pending a court decision. The consequence is that the bank is still under the control of the CP under the legal provisions cited at the time of the original intervention,[56] and the MFSA has not used its power to require the bank to wind up its business[57] or to appoint a CP to act as liquidator for the purposes of winding up the bank.[58] Given the lack of a deadline for a court verdict, this situation could persist for some time. In the meantime, loan assets are being repaid and the former bank is accumulating liquid assets that could otherwise be used to satisfy claims of creditors, including the DCS. In the meantime, the costs of the CP continue to accrue. This prolonged situation may adversely affect the recoveries of the DCS and other creditors.

37. As it moves forward with updating and streamlining the legal framework for bank insolvency proceedings, the government should develop an administrative rather than court-led bank insolvency framework. As noted, while the MFSA has the power to appoint a CP as liquidator of a bank, there are no clear administrative procedures for liquidation. Having an administrative bank insolvency regime would be consistent with the guidance in the international

[55] Aspects of the 1970s failure are still being adjudicated in the courts.
[56] Banking Act Art. 29 (1) (c) and (d) provisions allow the CP to take charge of the assets of a bank and to assume control of the bank's business and to act as the MFSA directs.

[57] Banking Act Art. 29 (1) (e).

[58] Banking Act Art. 29 (1) (f).

standard,[59] which recommends resolution authorities have the power to affect the closure and orderly liquidation of a failing bank.[60] Under such a framework, the RC would make decisions on the application of the insolvency regime rather than the MFSA Board in its supervisory capacity. This would serve to mitigate the potential for conflicts of interest within the MFSA stemming from its dual capacities as supervisory authority and resolution authority. Conflict may arise (i) in pursuing an objective to minimize its legal exposure for actions taken in its *supervisory capacity*, and (ii) in protecting the interests of depositors (and the DCS in subrogation of covered depositors) and creditors in its *resolution authority capacity*. In the meantime, the MFSA Board should seek to find a suitable means to shift decisions on the winding up and insolvency of a bank whose license has been withdrawn from its supervisory function to its resolution function.

38. The various current legal frameworks for bank insolvency proceedings appear not to allow the transfer of assets and liabilities to a third party at the time of license withdrawal.[61] Having this power would enable the conduct of a so-called "purchase and assumption" (P&A) transaction, whereby at least insured deposits are assumed, and certain assets are purchased, by an acquirer. A P&A transaction can result in a more orderly and efficient winding down of a bank, can be less disruptive to its clients, may allow retention of some franchise value associated with the bank's business, and can potentially reduce the costs for the DCS relative to a deposit payout. The availability of transfer powers could also increase the authorities' capacity to handle multiple non-systemic bank failures via a suitably improved bank insolvency regime. The availability of asset and liability transfer powers under the bank insolvency regime should be set out explicitly in law, ideally in advance of a full revision of the regime.

Special Resolution Regime

39. The RC has the tools and underlying special resolution powers set out in the international standard, and these are available to the SRB in Malta as well. The SRB can make use of these tools and powers for banks under its remit, and its decision to do so can be implemented directly by the RU without need for a separate decision by the RC, though the minister's approval may be required (see below). These tools are:

- *The bridge institution tool:* Based on the power to establish an institution temporarily owned by a public entity to acquire assets and liabilities[62] from a bank in resolution to ensure continuity of critical functions until a buyer can be found.

- *The sale of business tool:* The power to transfer assets and liabilities from a bank in resolution without shareholder or creditor consent to third parties or to a bridge institution.

[59] The FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions,* October 2014.

[60] See Key Attribute 3.2 (xii).

[61] These powers are only available under the "sale of business" tool of the Special Resolution Regime described below.

[62] Or, alternatively, an equity position.

- *The bail-in tool:* The power to write-down[63] and/or convert into equity eligible liabilities to absorb losses and recapitalize a bank in resolution.[64]

- *The asset separation tool:* The power to transfer assets that were not transferred when using the sale of business tool or not retained when undertaking a whole bank bail-in transaction, again without shareholder or creditor consent, to an asset management company (AMC) for the purpose of managing and maximizing the value of the assets.

40. The legal framework guiding the circumstances under which these resolution powers can be used is in place. In general, the powers are available whenever RC considers that insolvency proceedings would give rise to unacceptable financial or economic consequences. More specifically, the resolution powers may be used when:

- The bank is deemed to be "failing or likely to fail", a judgement that can be rendered by the SC/ECB or the RC/SRB;

- The RC/SRB, in consultation with the SC/ECB, determines that there are no reasonable prospects that adequate and timely private sector measures will be taken; and

- The use of the resolution powers is deemed by the RC/SRB to be in the public interest. The public interest determination is based on a judgment that the use of insolvency proceedings would not ensure that the objectives of resolution, namely ensuring continuity of the bank's critical functions, maintaining financial stability, safeguarding public funds, and protecting client assets and depositors will be met. In the case of banks under the sole remit of the RC, the basis for the determination by the RC is recorded in its meeting minutes.

41. The MFSA has the power to write down and convert capital instruments of a bank: as a stand-alone tool or in conjunction with taking resolution action. Under the Recovery and Resolution Regulations, a bank's equity can be written down or off, and its additional Tier 1 and Tier 2 capital instruments can be converted into equity or written down or off by either the SC or the RC. The SC can do so in order to ensure the viability of a bank. The RC can do so prior to or simultaneously with taking resolution action (as described below) and must do so where extraordinary public support (described below) is required. Prior to exercising the power to write down and/or convert capital instruments, the RC (but not the SC) must obtain a professional third-party valuation to determine the extent of losses on assets, with a view to ensure they are fully absorbed by existing capital instruments. In case this is not expedient, the RC can perform its own provisional valuation subject to adjustment based on an ex post third-party definitive valuation. At present, there are no written policies or procedures adopted by the RC and SC for coordinating the use of these respective powers, and consideration should be given to putting them in place.

42. In certain circumstances, the Finance Minister must grant permission prior to the RC exercising its resolution powers and can invoke the use of additional powers and tools

[63] Including to zero value (i.e., write-off).

[64] And potentially to help capitalize a bridge institution.

(government stabilization tools). As noted, the RC must seek the minister's written approval prior to taking any actions that may have a direct fiscal impact or which may have systemic implications. In addition, in the extraordinary circumstance in which the resolution tools cited above prove inadequate, the minister may, in consultation with the RC, direct the use of government stabilization tools involving equity support from the state and/or temporary public ownership.[65] While communications between the RU/RC and the MFIN appear adequate, there would be benefit in the MFIN clarifying its expectations for notifications under these provisions, and for formulating written policies and procedures as to when and how government stabilization tools might be utilized.

43. The legal safeguards for shareholders and creditors set out in the international standard are in place. Among these safeguards, shareholders and creditors are protected from incurring losses in the context of the use of resolution powers that are greater than they would have incurred under insolvency proceedings (the so-called "no-creditor-worse-off" principle). If left financially worse off, based on a professional third-party valuation, they are entitled to compensation from the SRF.[66] While the resolution powers must be exercised in a manner that respects the hierarchy of claims set out in the Recovery and Resolution Regulations, the power to deviate from *pari passu* treatment of creditors, such as excluding certain creditors from bail-in, under specifically defined and limited circumstances, is in place.

44. The effective application of the "no-creditor-worse-off" principle is compromised by uncertainties in the bank insolvency framework. As it is unclear what creditor hierarchy would apply, it is unclear against which legal provisions the authorities can assess whether creditors would potentially be left worse off in the application of resolution measures relative to insolvency. At the least, this situation introduces legal risk into any decisions taken by the RC in applying the resolution tools.

45. The legal framework provides the RC with wide-ranging powers to seek to remove impediments to resolution. It has adequate powers to require changes to enhance resolvability of banks and groups, including banks. These measures include, *inter alia*, requiring a bank to limit its maximum individual and aggregate exposures, divest specific assets, limit or cease specific activities, and change its legal or operational structure.

46. Parties aggrieved by a decision or actions of the RC[67] can appeal directly to the Court of Appeal within 20 days.[68] Appeals do not automatically suspend the effects of the resolution measure and the decision is immediately enforceable. An annulment by the court of a decision by the RC does not affect any subsequent administrative acts or transactions based on the annulled decision (to protect the interests of third parties who have acquired shares, assets, rights, or

[65] Subject to prior approval by the European Commission Directorate-General for Competition in line with the EU state aid framework. The government elected not to transpose the BRRD provisions for precautionary recapitalization in that this would require the taking over of shareholder (constitutional) rights.

[66] The SRF is discussed in Part E of this Section of Note.

[67] Including both so-called "crisis prevention measures" and "crisis management measures."

[68] Art. 9, First Schedule MFSA Act.

liabilities of an institution under resolution); rather, the legal remedy is compensation for any loss incurred by the aggrieved party as a result of the decision or consequent actions.

47. Use of the special resolution powers cited above has yet to be tested. Since the effective date of the amended MFSA Act, the MFSA has made two "failing or likely to fail" notifications to the RC. In both cases, the RC determined that use of its resolution powers was not indicated under the public interest test. This reinforces the view expressed earlier that the RC is operationally independent of the MFSA's supervisory functions.

48. Summary of recommendations:

- As a priority, initiate a project to update and streamline the legal framework for bank insolvency, taking into consideration the guidance in the international standard to adopt an administrative regime;
- Amend the law to set out explicitly the availability of asset and liability transfer powers in insolvency;
- Find a suitable means to shift responsibility for decisions on the winding up and insolvency of a bank whose license has been withdrawn from the MFSA's supervisory function to its resolution function;
- Consider adopting policies and procedures for coordinating how the RC and SC use their power to write down and convert capital instruments;
- Consider clarifying in writing expectations regarding notifications by the RC to the minister when taking actions that may have a direct fiscal impact or which have systemic implications; and
- Consider adopting written policies and procedures as to when and how government stabilization tools might be utilized, in conformity with EU state aid obligations.

D. Resolution Planning, Strategies, and Impediments

49. The SRB and RU lead resolution planning. For the four banks under the authority of the SRB,[69] resolution plans are prepared by the SRB Internal Resolution Teams supported by staff from the RU in consultation with BSU staff.[70] For other banks, the plans are being prepared by the RU and will be endorsed by the RC and sent for comment to the SRB and the MFSA Board (as the Resolution Authority). The inter-agency DSC[71] is kept informed of the status and any significant issues arising in the course of resolution planning.

[69] This includes the three banks designated as SIs by the ECB, as well as a Malta subsidiary of a euro area bank headquartered in another jurisdiction. Overall responsibility for one SI lies with the Bank of England.

[70] And in certain circumstances, CBM staff.

[71] See Part G of this Section of the Note.

50. Resolution planning remains a work in progress. Resolution plans for two of Malta's three SIs were prepared starting in 2016 and are now undergoing their third annual iteration. The resolution plan for the third SI is the responsibility of the Bank of England-led Crisis Management Group,[72] and the SRB and the RC are working to ensure more explicit and complete treatment of the Malta subsidiary in that plan. In late 2017, the RU initiated resolution planning for banks designated as HP-LSIs. Initial resolution plans for two of the HP-LSIs is expected to be completed in 2018, and for the third in early 2019. Resolution plans for certain problem banks have also been developed. Initial plans for other banks are expected to be completed by end-2020. In general, resolution plans in most cases have not yet achieved the ultimate goal that they be credible[73] and feasible.[74] Continued effort in resolution planning is necessary and efforts should be made to accelerate the timetable for any particularly weak small banks.

51. Formal resolution planning by the authorities for the two dominant life insurers has not yet been initiated. As noted, the feedback provided by the MFSA's Insurance and Pensions Supervision Unit on the insurers' internal Own Risk and Solvency Assessment appropriately addresses recovery and resolution planning by the firms. There is scope for the MFSA, including the RU, to consider possible resolution measures for the insurers, and the consequences for the insurers of resolution of the banks with which they are associated, and vice versa. Responsibility for resolution planning for *significant insurers* should be assigned within the MFSA and work initiated, ensuring integration into the plans of the relevant banks.

52. A key component of resolution planning is to decide on the preferred resolution strategy (PRS) for each bank. The PRS for a bank could specify the use of one or more of the resolution tools or, alternatively, the use of insolvency proceedings.[75] The PRS for one SI has been agreed with the SRB and the PRS for the other two SIs are likely to be agreed soon. Further analysis is required to determine fallback resolution strategies for the three SIs in the event the PRS is deemed not feasible at the time of resolution, and this should be pursued. In principle, the default PRS for all banks is use of insolvency proceedings. As noted, the use of resolution tools must meet a series of tests, including that of being in the public interest.

53. Upon agreement on the PRS for each bank, a minimum requirement for eligible liabilities (MREL requirement) is determined. The MREL requirement aims to ensure banks have adequate loss-absorbing capacity and recapitalization funds to support the effective

[72] Essentially, a joint supervisory and resolution college established under the auspices of the Financial Stability Board in Basel for all *globally systemically important banks*, such as HSBC.

[73] Credible in the sense that the authorities have the necessary legal and operational capacity to implement the plan.

[74] Feasible in the sense that the plan can be implemented without causing substantial disruption to the financial system.

[75] The weaknesses of the bank insolvency regime in Malta are problematic in this context, as they may create pressure to use the resolution regime for non-systemic banks due only to uncertainty regarding outcomes under the insolvency regime. Thus far that has not been the case, but mitigating this risk provides additional rationale to prioritize legislative reform to the bank insolvency regime.

implementation of the chosen resolution tool.[76] The SRB specified indicative MREL targets for all SIs in 2017, and thus far in 2018 has set a binding external target for the SI for which a PRS has been agreed. Binding external targets for the two other SIs are anticipated soon.[77] Specific MREL requirements for other banks have not been set either by the RU, though adequate progress is being made.[78]

54. Through the process of resolution planning, impediments to resolution are being identified. The RU is working with the SRB and the banks to resolve potential impediments. Key potential impediments include:

- *Ensuring the ability to provide adequate liquidity for a bank in resolution*. The two last-resort sources of liquidity funding in resolution are emergency liquidity assistance (ELA) from the CBM and use of the SRF.[79] The SRB, however, precludes the consideration of either in formal resolution planning.[80] The RU therefore will need to consider other planning approaches. In particular, the RU (and banks) should be as cognizant as possible of CBM's ELA framework,[81] to ensure that a bank in resolution is able to meet the CBM's requirements should it be deemed eligible for ELA at the time of resolution.[82]

- *The lack of practically "bail-inable" liabilities in Malta*. Potentially bail-inable instruments generally include total own funds, subordinated debt, senior debt, and, prospectively, senior nonpreferred debt.[83] Other potentially bail-inable instruments include uncovered (uninsured) corporate deposits. The market structure and demand in Malta are such that banks' debt instruments, including subordinated debt, are purchased in significant volume by retail customers, even where the minimum denomination is relatively high (e.g., €25,000). Moreover, a large proportion of Malta's corporate depositors are qualified as "small and medium enterprises" under the EU definition. Issuing sufficient MREL may therefore prove challenging for banks, considering the limited domestic professional investor market and issuance sizes that may be small for potential external investors. These market realities have been conveyed to the SRB. The

[76] Should bank insolvency be the PRS, an MREL requirement in addition to regulatory capital requirements, might not be deemed necessary.

[77] The target for one SI is a function of the Total Loss Absorbing Capital requirement applicable to *global systemically important banks*.

[78] Insolvency may be the PRS for nearly all other banks, notwithstanding the weakness in the framework described in this Note.

[79] Both are discussed in detail in Part E of this Section of the Note.

[80] Including precluding any consideration of the SRF as a source of recapitalization funding.

[81] For example, its policies on eligible alternative collateral, valuation procedures, information requirements and haircuts, and documentation requirements to support perfecting liens on collateral.

[82] See Part E of this Section of the Note for recommendations regarding the CBM's ELA Framework.

[83] This is a new class of debt that is subordinate to a range of other unsecured creditors, the framework for which was adopted in the EU in 2017.

banks, the SRB, and the RU will need to work collaboratively to ensure MREL requirements are able to be met with instruments that can be bailed-in in practice.

55. The feasibility and credibility of the bail-in tool can be constrained by compensation claims that can arise when departing from *pari passu* treatment of creditors. In bail-in, the RC can depart from *pari passu* treatment of creditors in the same class under certain circumstances.[84] Under the creditor hierarchy,[85] uninsured depositors (with the exception of uninsured household and "small and medium enterprise" depositors) and senior unsecured bondholders[86] rank in the same creditor class. With *pari passu* treatment in imposing losses in resolution, uninsured depositors would incur the same loss as would senior unsecured bondholders. Alternatively, protecting uninsured depositors but not senior unsecured bondholders would potentially give rise to valid "no-creditor-worse-off" claims on the part of bondholders, who may be left worse off in resolution than they would have been had the bank been put into insolvency proceedings. "No-creditor-worse-off" claims must be paid by the SRF, and SRF access criteria give rise to yet additional challenges that must be taken into consideration.[87] Also, without a departure from *pari passu* treatment, use of bail-in potentially would convert uninsured depositors to shareholders.

56. The lack of flexibility to depart from the *pari passu* principle may constrain the effective implementation of sale of business (and bridge bank) tools. As noted, Maltese legislation explicitly allows for departures from the principle of *pari passu* when using the bail-in tool.[88] The ability to depart from the *pari passu* treatment of creditors within a class should also be explicitly available for the application of the sale of business tool and the bridge institution tool. For example, this may be necessary to allow for the transfer of certain liabilities (e.g., uncovered corporate deposit liabilities), but not the other liabilities within the same ranking (e.g., senior unsecured bonds). While it may be possible to read such flexibility into the Recovery and Resolution Regulations, consideration should be given to making explicit in law the power to depart from *pari passu* treatment of creditors when using the sale of business and bridge institution tools to reduce the potential of legal challenges arising from the lack of express authority.

57. The use of a bridge institution can serve as an effective fallback solution where a suitable arrangement with a private sector acquirer under a sale of business tool transaction cannot be achieved. For example, where the RU/SRB are unable to conclude a private sale within the required timeframe or on acceptable terms, critical functions could be transferred to a bridge bank and subsequently sold to the private sector. Under the Recovery and Resolution Regulations, any bridge institution is to be controlled by the RC but can be owned in whole or part by one or

[84] For instance, for operational practicality or financial stability reasons, or to maximize value for all creditors. This could provide the basis for excluding uninsured corporate deposits from bail-in, for example.

[85] Banking Act Art. 29a.

[86] As well as trade creditors.

[87] See Part E of this Section of the Note.

[88] The FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions recommend that while, in principle, the hierarchy of claims is to be respected, resolution authorities should have the flexibility to depart from the *pari passu* principle when necessary to contain the potential systemic impact of a firm's failure or to maximize the value for the benefit of all creditors.

more public authorities. Following SRB guidance and policies, the RU began to prepare a handbook for operationalizing a bridge institution. A priority in this effort should be to define which entity will own a possible bridge institution and how the ownership function will be organized, how the institution's governance structures will be rapidly put in place in time of need, and how the bridge institution will be returned to the private sector in a timely manner. Collaboration with the MFSA Authorizations Unit will be important and is encouraged.

58. Preparations are also being made to operationalize an AMC to enable use of the asset transfer tool. Based on guidance available from the SRB, the RU has prepared a first draft of a regulation. As with bridge institutions, the regulation should define which entity will own a possible AMC and how its governance structures can be rapidly established in time of need.

59. As noted, prior to taking a decision to initiate resolution, or to write down and/or convert capital instruments, the RC must arrange for a third-party valuation. Contracting for this purpose is subject to government procurement rules. The RU has held initial discussions with MFSA's Procurement Office but will seek SRB guidance on valuations before proceeding with procurement. Consideration should be given to contracting with at least two firms that can commence required valuations on short notice (e.g., within five days). (A single firm is impractical because of a possible conflict of interest arising from its business relationships with the bank in resolution.)

60. The RU intends to prepare handbooks to guide implementation of each of the resolution tools as its disposal. As noted, the SRB is providing guidance for this exercise. The handbooks should contain policies and procedures relevant to each tool. This will require substantial effort and is among the key tasks facing the RU. The handbooks should be developed as soon as possible.

61. Summary of recommendations:

- Continue efforts in resolution planning and consider means to accelerate resolution planning for any particularly weak small banks;
- Assign responsibility for development of formal resolution plans for *significant insurers* within the MFSA and initiate the work, ensuring integration with the plans of the relevant banks;
- Consider approaches to mitigating the potential that lack of access to sufficient liquidity funding proves an impediment to effective implementation of resolution tools;
- Continue collaboration with the SRB to ensure MREL requirements are able to be met with instruments that can be bailed-in in practice under Malta's market circumstances;
- Consider making explicit in law the power to depart from *pari passu* treatment of creditors when using the sale of business and bridge institution tools;
- Develop plans to establish a bridge institution and an AMC, including defining which entity will own the legal entities, how the ownership function will be organized, how their governance

structures can be rapidly established in time of need, and how the institution or assets will be returned to the private sector in a timely manner;

- Contract with at least two firms that can, on short notice, commence valuations required to support use of resolution tools; and
- Develop handbooks to guide implementation of each of the resolution tools.

E. Resolution Funding

62. There are several sources of funding for implementing resolution measures. Subsequent to the write-down and/or conversion of capital instruments and other liabilities eligible for bail-in, financing may be required for recapitalization of a resolved bank and for maintaining adequate liquidity prior to, during, and subsequent to executing resolution measures.[89] The sources are the SRF, ELA, and public financing subject to conformity with EU state aid rules.

Single Resolution Fund

63. The Single Resolution Mechanism Regulation establishes the SRF. It is owned and administered by the SRB. Subject to certain conditions, the SRF may fund loss absorption, recapitalization, liquidity, and other costs and expenses associated with resolution measures.[90] Under exceptional circumstances and subject to certain conditions, the SRF can make contributions to the institution under resolution in lieu of the write-down or conversion of certain liabilities and/or creditors.[91] The SRF also is the source of any compensation to shareholders or creditors under any successful "no-creditor-worse-off" claims.

64. The amount of SRF funding potentially available for resolution measures with respect to Maltese banks was roughly €16.6 billion as of end-2017. This is comprised of the funded amount of the Malta compartment of €23.3 million, a €43 million bridge-financing arrangement in the form of a Loan Facility Agreement from the state[92] for the unfunded portion of the Malta compartment, and the remainder from the mutualized compartments. For potential funding needs in Malta, the SRF is of ample size.

65. Conditions on certain uses of the SRF may constrain its effectiveness. A prerequisite for access to the SRF for loss absorption and recapitalization support (but not liquidity support) is that shareholders and creditors have collectively first absorbed losses of at least 8 percent of total

[89] In extraordinary circumstances, financing may be required for loss absorption (i.e., to restore capital to zero).

[90] This includes the ability to make capital contributions, issue guarantees, make loans, and purchase assets.

[91] Single Supervision Mechanism Regulation Arts. 27 and 76, BRRD Art. 44 (4) and Recovery and Resolution Regulation 44 (4).

[92] The Loan Facility Agreement is the standard bridge financing agreement entered into by Banking Union participating states. It allows the SRB to draw funds without any further authorization or agreement of the Maltese government or legislature.

liabilities and the bank's own funds.[93] As noted in the Euro Area FSAP Technical Note,[94] this requirement may impede the implementation of any resolution tool necessitating use of the SRF (e.g., when there are insufficient bail-in-able liabilities to meet the 8-percent rule). Given the market characteristics described above, this is likely to prove a particularly binding constraint in Malta. The potential inability to access the SRF highlights the importance of improving the insolvency regime and putting in place explicit asset and liability transfer powers in insolvency, as recommended in Part C of this Section of the Note. In any case, and despite the fact that the SRB precludes consideration of the use of the SRF in resolution plans, the RU needs to consider how restrictions on use of the SRF may impede resolution and how to remedy or mitigate those impediments.

Emergency Liquidity Assistance

66. The provision of ELA to Maltese banks is at the discretion of the CBM. In the Banking Union, ELA may be granted by the national central banks, subject to potential objection by the ECB.[95] The ECB and the national central banks, including the CBM, have entered into the non-binding Agreement on Emergency Liquidity Assistance.[96] Under the Central Bank of Malta Act, the CBM may grant a loan to any bank incorporated in Malta (against such forms of security as the CBM Board may consider appropriate) where it deems that doing so is necessary to safeguard financial stability. ELA is not available to institutions other than banks. When granting ELA, the CBM bears the risk of any loss; there are no provisions in place for an MFIN guarantee of ELA. No ELA has been provided to a Maltese bank over the past five years.

67. The CBM has recently adopted a formal ELA Framework,[97] which elaborates upon relevant authorities, responsibilities, policies, and procedures. The framework is comprehensive, addressing matters that are relevant to considering, deciding upon, implementing, monitoring, adjusting, reporting upon, and exiting possible ELA. The framework also addresses coordination internally among CBM units and with other parties such as the MFSA and the ECB. In its treatment of ELA collateral, the framework addresses well the eligibility of a wide range of collateral and the valuation and haircut procedures applicable to various types of financial and physical collateral. Additional work should be undertaken to document the legal and procedural requirements for perfecting liens on "non-traditional" forms of collateral (i.e., those not used in regular monetary operations, such as loans).

[93] A second constraint is that the amount provided by the SRF is limited to five percent of the bank's total liabilities and own funds.

[94] IMF Country Report No. 18/232, *Euro Area Policies: Technical Note – Bank Resolution and Crisis Management*, July 2018.

[95] The ECB's Governing Council can object to CBM ELA if it finds the ELA conflicts with the objectives and tasks of the ESCB or constitutes monetary financing of bank support. There are established procedures for *ex post* and *ex ante* notification of ELA to the Governing Council by national central banks. Any ELA outstanding would be reviewed by the Governing Council regularly.

[96] The May 2017 Agreement sets out guidance and requirements for notifications by NCBs to the ECB Governing Council, solvency criterion, interest rates, duration, and communications to the public.

[97] *Framework for the Provision of Emergency Liquidity Assistance by the Central Bank of Malta*, July 2018.

68. The eligibility criteria under the CBM's ELA framework includes both a systemic risk and solvency test. To assess whether providing ELA is warranted, the CBM has procedures in place for carrying out a systemic impact assessment. The objective is to ascertain whether inaction by the CBM could lead to the failure of an otherwise viable bank, or to a high risk of contagion, which could have systemic repercussions on the financial system and/or real economy. Consistent with the ELA agreement between the European Central Bank and national central banks, the solvency assessment may consider prospective solvency, such as could be achieved by resolution actions taken by the RU. Both assessments are undertaken by the CBM's Financial Stability Department.

69. The CMB ELA framework has been shared with other members of the DSC (i.e., the MFSA and the MFIN), but not with the banks. The ELA framework serves in large part as the CBM's internal crisis preparedness regime, and awareness of that regime among DSC members was deemed important and valuable. Not sharing certain elements of the plan with banks may pose financial stability risks. In the context of their own contingency planning, banks need to understand what collateral is potentially eligible for ELA and what are the CBM's policies for valuation, haircuts, and information and documentation requirements. Without prejudice to its sole discretion to decide on granting ELA, the CBM should make its high-level policies in this respect known to banks, especially those that might be potentially eligible for ELA.

70. The CBM has no arrangements in place to provide ELA in foreign exchange (FX), the need for which, however, the CBM judges as a remote possibility. In Malta only one mid-size bank operates significantly in FX (USD). Beyond market sources, the CBM would most likely seek FX from the ECB, which has swap lines in place with the United States and other key central banks. The CBM should consider whether to explore discussions with the ECB regarding access to FX as a contingency.

71. There is no government backstop for ELA. The situation can arise where the CBM may deem that a bank in resolution meets its systemic risk and solvency criteria, but where the bank is unable to provide sufficient collateral or, more likely, is unable to provide the documentation necessary for the CBM to promptly perfect liens on the collateral the bank can offer. In such a case, the CBM would be lending partially unsecured, albeit perhaps for only a short period of time. The CBM and the MFIN should consider putting in place arrangements for a government guarantee of any unsecured lending by the CBM. Both entities would need to agree to support the liquidity of a bank in resolution, and subject to any state aid rules.

Government Backstop Support

72. The minister has the power to borrow funds for implementing the provisions of the Recovery and Resolution Regulations,[98] including for the purpose of implementing government stabilization tools and to fund "public backstop measures" for other resolution funding arrangements. The minister is authorized to borrow "for such amount not exceeding any amount which the House of Representatives may from time to time by resolution authorize." This provision is interpreted as requiring prior House approval. The MFIN states there are examples of convening

[98] Art 9 (1) of the Government Borrowing and Debt Management Act.

parliament on short notice for urgent matters. The MFIN should seek to clarify whether these provisions enable the government to provide, as a last resort, a borrowing facility for the DCS (see next part of the this Note) and backstop for CBM ELA, subject to prior approval by the European Commission Directorate-General for Competition and in compliance with the EU state aid rules.[99]

73. Summary of recommendations

- Consider how restrictions on use of the SRF may impede resolution and how to remedy or mitigate those impediments;
- Undertake further work to document the legal and procedural requirements for perfecting liens on non-traditional forms of collateral;
- Without prejudice to the CBM's sole discretion to decide on granting ELA, make high-level policies for collateral valuation, haircuts, and information and documentation known to banks to aid their contingency funding planning;
- Consider discussions with the ECB regarding access to FX for ELA as a contingency;
- Put in place arrangements for a government guarantee of any unsecured lending by the CBM, subject to EU state aid rules; and
- Clarify that the minister's power to borrow in support of implementation of provisions of the RR Regulation enable it to provide a borrowing facility for the DCS and a backstop for CBM ELA, subject to prior approval by the European Commission Directorate-General for Competition and in compliance with EU state aid rules.

F. Deposit Protection and Payout

74. The Deposit Guarantee Scheme Directive created a common EU framework. It introduced harmonized coverage of deposits at €100,000, a requirement for faster payout (seven days), and *ex ante* funding arrangements. The scheme requires that premiums be risk-based and that by July 3, 2024, each national scheme shall reach a target level of at least 0.8 percent of covered deposits.

75. The Malta DCS was established in 2003 and its legal foundations were amended in late 2015 with the transposition of the Deposit Guarantee Scheme Directive. The DCS covers resident and nonresident depositors in banks licensed in Malta and their branches in the EU. It does

[99] Based on the position expressed by the EU Council Legal Service, it is understood that the government financial stabilization tool provided for in the BRRD are currently only available for use outside the Single Resolution Mechanism (for example, by non-euro area member states). Accordingly, such tools would not be available in member states participating in the mechanism. The 2018 euro area FSAP recommended that the EC "Ensure that financial stability tools (e.g., government guarantees, recapitalization) are available and can be effectively employed in all member states." For further clarification, see the Financial Sector Assessment Program-Technical Note-Bank Resolution and Crisis Management.

not cover depositors in branches in Malta of banks licensed outside the EU, nor does it cover deposits by other banks or investment firms, deposits by collective investment schemes or other investment funds, and most deposits by pension and retirement funds.[100] Covered deposits as of June 30, 2018, were €11.6 billion, representing 62 percent of the €18.8 billion in eligible deposits[101] and 54 percent of the €21.6 billion in total deposits. DCS assets are kept in accounts at the CBM, which also serves as investment manager for the fund.

76. The DCS targets a fund balance of 1.3 percent of covered deposits. This level was reached in 2016. The target fund balance for 2017 was €141 million, though a deposit payout of €35 million that year reduced the fund balance by about 25 percent. At the 1.3 percent target fund size, the DCS has insufficient resources for a full payout of the SIs and five individual LSIs, the smallest of which has roughly a 2 percent market share in total deposits. The DCS has the authority to enter into agreements with third parties to obtain additional financing to increase its resources or to raise cash. In one instance, the DCS explored obtaining a loan from commercial banks but was unsuccessful and entered into a repo transaction with the CBM to raise cash.[102] No backstop funding arrangements are in place. The DCS should continue to pursue additional funding sources in times of need, including secured with future premiums, ideally from commercial banks, but, as a last resort, from the government.[103]

77. In 2012 the MFSA adopted a policy with respect to new entrants designed to protect the DCS. In February 2012, it adopted the policy setting out a general expectation that new entrants should have a bank of established repute in their shareholding and/or management structure. In May 2012, the MFSA adopted a policy that would take into consideration in its authorization process the means of funding by new entrants that would not be covered by the DCS, particularly for those potential entrants that do not have a bank of established repute in the shareholding or management structure. Subsequently, licenses have been granted to eight banks under the condition that they agree to maintain blocked funds in their account at the CBM in favor of the DCS, with six banks required to maintain blocked funds equivalent to 100 percent of their covered deposits, and two banks required to maintain blocked funds of 15 percent of their covered deposits.[104]

78. The DCS is financed through *ex ante* contributions imposed on banks. The risk-based premiums are determined by the DCS Management Committee. Regular annual premiums take the form of payment commitments and cash contributions. At present, the payment commitment

[100] Deposits held by personal pension schemes and occupational pension schemes of small or medium-sized enterprises are covered.

[101] Deposits held by clients eligible for coverage.

[102] The context was the 2017 payout, where the DCS found it less expensive to use a repo transaction to borrow from the CBM against certain securities than to borrow from a commercial bank. As noted, DCS securities are maintained in accounts at the CBM.

[103] In compliance with State Aid rules.

[104] Banks qualify for the lower 15 percent requirement if they agree to maintain total capital plus debt eligible for bail-in (raised from professional investors) greater than 35 percent of covered deposits.

represents 63.5 percent of the total annual premium but must be reduced to 30 percent by 2024. Of the current fund balance of €111 million, 86 percent is comprised of payment commitments.[105] The DCS can require banks to make extraordinary contributions in an amount of up to 0.5 percent of covered deposits each year if its resources are deemed insufficient.

79. The DCS is seeking an amendment to the DCS Regulation to mitigate the 2017 depletion of the fund. As noted, the DCS paid out €35 million in covered deposits, representing 25 percent of its €141 million fund. At the time of writing of this note, Parliament was expected to consider an amendment to enable the DCS to require banks to issue additional payment commitments of €35 million, an amount equal to the recent payout. Banks would have to fulfill the commitment in four annual contributions, unless the DCS recoups its outlays during that period. This legal amendment should continue to be pursued.

80. At present, the DCS is required to make payouts within 20 days. Under the Deposit Guarantee Scheme Directive this period must be reduced to seven days by 2024. The DCS is implementing an automated system in which banks would send data files to the DCS to enable payouts within the seven-day period. The system is envisaged to be operational by end-2018. The system enables payouts to depositors either by means of checks issued by the CBM or by transfer of covered deposit amounts to a pre-specified deposit account at another bank. Over time, consideration could be given to complementary payout methods. One option involves creating a portal where covered depositors can designate an account at another bank to which to transfer the paid-out funds. This would be more flexible than the existing pre-designated account approach. Another option is to use an agent bank to make payouts, which might be more convenient for depositors than receiving a CBM check.

81. The DCS has the power to finance the transfer of assets and liabilities in the context of insolvency proceedings.[106] This power to finance P&A transaction, is subject to a provision that the costs borne by the DCS in such transfers do not exceed the net amount of paying out covered depositors. However, the apparent lack of MFSA or DCS power to transfer assets and liabilities to a third party under bank insolvency proceedings noted in Part C of this Section of the Note would seem to preclude the use of this financing option. Moreover, as noted, uncertainties regarding the insolvency regime extend to a lack of clarity as to the creditor hierarchy in insolvency and thus the status of the DCS's claim in subrogation of covered depositors. Consequently, it is unclear how to determine the net amount the DCS would incur in paying out covered deposits. The DCS should clarify in writing its interpretations of current law and its policies in this regard.

82. The DCS has the power to finance resolution actions in certain cases. Specifically, in the context of bail-in, the DCS is liable for the amount by which covered deposits would have been written down to absorb the losses in the bank, had covered deposits been included within the scope

[105] Payment commitments are backed by a written agreement between the bank and the DCS binding the bank to pay the DCS the committed amount in cash within two days (and potentially one day) of demand by the DCS. Payments are secured by a pledge of high-quality securities.

[106] Regulation 33 (6), DCS Regulations.

of a bail-in and been written down to the same extent as creditors in the same level of the creditor hierarchy.[107] If resolution tools other than bail-in are employed, the DCS is liable for the amount of losses that covered depositors would have suffered in proportion to the losses suffered by creditors in the same level of the creditor hierarchy. That said, the DCS's liability cannot exceed the net losses that would result under insolvency proceedings. Again, however, there is no certainty as to the status of the DCS's claim in subrogation of covered depositors, which renders it unclear what net loss it might incur in insolvency. In any case, here too the DCS should clarify in writing its interpretations of current law and its policies. An interpretation allowing the DCS to finance resolution measures up to the amount it otherwise would have paid out to depositors under insolvency--providing that it is reasonably expected to recover those funds to the same degree as in liquidation--would increase resolution funding options.[108]

83. The MFSA determines when the DCS is triggered. Should the ECB withdraw a bank's license (which, as noted, would occur upon the recommendation of the MFSA Board acting as the supervisory authority), the MFSA notifies the DCS, which triggers a deposit payout.[109]

84. The DCS does not have explicit legal power to put a bank into liquidation.[110] This limits the ability of the DCS to protect its interests. As noted, license withdrawal by the ECB triggers a notification by the MFSA Board to the DCS, triggering a deposit payout. Should the MFSA Board not place the bank into liquidation, as in the current Nemea Bank case, the DCS may not be able to recoup its paid-out funds, because it is conceivable that the cost of maintaining the former bank in abeyance of liquidation will deplete its available assets. This situation will affect the recovery by other creditors as well. These concerns should be remedied in any amendments to current law or in the broader update and streamlining of the bank insolvency framework to create an administrative regime for the orderly closure and liquidation of a failing bank.[111] In the meantime, the MFSA should adopt a policy to place a bank into liquidation when a deposit payout is made.

85. The DCS needs to be prepared to play a lead role in creditor-led insolvency proceedings. Notwithstanding the significant uncertainties regarding the legal regime for bank insolvency, it is likely that the DCS, in subrogation of paid-out covered depositors, will be the largest claimant on most, if not all, bank liquidation estates. This may place certain duties upon the DCS in the context of any creditor-driven liquidation process; for example, as is provided for in the Companies Act.[112]

[107] Regulation 109, Recovery and Resolution Regulations.

[108] See: *Resolution Funding: Who Pays When Financial Institutions Fail?;* Oana Croitoru, Marc Dobler, and Johan Molin at: https://www.imf.org/en/Publications/TNM/Issues/2018/08/16/Resolution-Funding-Who-Pays-When-Financial-Institutions-Fail-46124.

[109] Regulation 8 of the DCS Regulations.

[110] There are provisions in the Companies Act under which creditors, including the DCS, can force a company into liquidation.

[111] The law should require that license revocation triggers liquidation.

[112] Creditor's Voluntary Winding-up Under Part V, Title II, of the Companies Act.

86. Summary of recommendations:

- Continue to pursue efforts to obtain additional funding sources, ideally from commercial banks but, as a last resort, from the government, in compliance with state aid rules;
- Continue to pursue an amendment to the DCS Regulation to allow a replenishment of the fund;
- Consider eventually adopting additional payout mechanisms;
- The DCS should clarify in writing its interpretations of current law and its policies on its ability to finance the transfer of assets and liabilities in insolvency, and to finance the use of resolution measures;
- The MFSA should adopt a policy to put a bank into liquidation when a deposit payout is made; and
- The DCS should be prepared to take a leading role in any creditor-led liquidation process.

G. Contingency Planning and Crisis Management

87. The authorities have well-defined institutional arrangements for interagency coordination in the context of threats to financial stability and financial crisis. These are the Joint Financial Stability Board, which serves as coordinating body for the CBM and the MFSA in matters potentially affecting financial stability,[113] and the DSC—with its broad membership, including the MFIN—with responsibility for financial crisis preparedness and management.

88. The Joint Financial Stability Board is a statutory body under the Central Bank of Malta Act. Chaired by the governor, it is also comprised of the two CMB deputy governors and the MFSA Chairman and CEO. The minister normally attends as a non-voting member. The board's decisions routinely are taken by consensus. The board meets quarterly and plays essentially an advisory role—its recommendations, advice, or assessments are to be taken into consideration by the relevant authority, and the authorities are to seek the opinion of the board prior to taking action that may impact on financial stability.

89. The DSC is a body established by agreement of the members. It is chaired by the CBM deputy governor responsible for financial stability and is comprised in addition by the CBM Chief Officer responsible for financial stability, the CBM Financial Stability Department Head, the MFIN Budget and Finance Permanent Secretary, the MFSA Director General, and the MFSA RU Head. The DSC often invites the Financial Intelligence Analysis Unit,[114] and occasionally the Attorney General and the Malta Stock Exchange, to participate as observers at the DSC meetings. The DSC mandate is

[113] The Minister may appoint a representative to participate as a non-voting observer at meetings of the Joint Financial Stability Board.

[114] The Financial Intelligence Analysis Unit is a government agency established under the Prevention of Money Laundering Act.

both to enhance crisis preparedness in normal circumstances and to facilitate the management and resolution of an actual crisis. It serves as a forum to exchange views, evaluate, and consult on matters of mutual interest.

90. The Crisis Management Task Force serves as the permanent operational arm of the DSC. It is chaired by the MFSA RU Head and is comprised of technical personnel from the CBM, the MFSA, and the MFIN. Its primary objectives are to maintain and update the interagency Framework for the Management of Domestic Financial Crises (Interagency Crisis Management Framework), to organize simulation exercises to test parts of the framework as directed by the DSC, and to make recommendations to enhance the regimes for recovery, insolvency, and resolution. At present, the Task Force is focused on updating the Interagency Crisis Management Framework to reflect changes in responsibilities associated with the introduction of the Single Supervision Mechanism and the Single Resolution Mechanism, guidance provided by the ECB and the SRB, and the findings of a recent crisis simulation exercise (see paragraph 91).

91. The authorities engaged in a crisis simulation exercise in 2016. The participants included the senior management of the CBM, the BSU, the RU, and the MFIN. The objectives were to assess reporting lines, escalation processes, response prioritization, collaboration, and decision making in line with policies and procedures.[115] As noted, one key outcome was to identify the need to update the Interagency Crisis Management Framework. The exercise also highlighted the need to be better prepared to take decisions on whether to use the insolvency regime or resolution measures in individual banks,[116] and the need to improve the ELA framework.[117]

92. In conjunction with work to upgrade the Interagency Crisis Management Framework, the authorities should ensure their own internal crisis management plans are adequate. While the CBM's well-elaborated ELA framework largely serves that purpose, the MFSA and the MFIN at present do not have well-documented crisis management plans in place. Internal contingency plans are an important complement to a comprehensive interagency plan. Efforts to put them in place should begin. In the case of the MFSA, this would complement the work of the RU to prepare handbooks for using various resolution tools. Many of the recommendations in this Note call for the authorities to adopt formal written policies and procedures. These would best be reflected in their internal crisis management plans. The completed plans should be shared with the other agencies.[118] The agency-specific plans should be reviewed and updated periodically, with relevant updates and then incorporated into the interagency framework.

[115] The scenario involved a bank experiencing serious difficulties due to the failure of a borrower representing a large credit exposure.

[116] For example, by putting in place a specified decision-making framework and ensuring the ready availability of information required under the framework.

[117] Mainly to improve collateral valuation techniques and processes.

[118] As noted, the CBM's ELA Framework has been shared with the MFSA and the MFIN.

93. The institutional architecture for the Banking Union was largely designed with resolution of individual banks and banking groups in mind. The specified interactions between the MFSA, the RC, the SRB, the EC, and the Council on the adoption of a resolution scheme contemplate the failure of an individual institution or group. However, a system-wide crisis involving simultaneous distress and potential failure of multiple banks and other financial institutions would involve additional participants (e.g., the CBM, the MFIN) and require a more comprehensive strategy. At present, there can be ambiguity as to which authorities would be responsible for the design, implementation, and public communication of such a strategy and how the various authorities would coordinate their activities. As an eventual part of their efforts to update the Interagency Crisis Management Framework, the Crisis Management Task Force and the DSC should consider how the domestic agencies would interact with European authorities in the event of a system-wide crisis, potentially involving other euro area jurisdictions, and have in place appropriate contingency plans to ensure financial stability in Malta.

94. Summary of recommendations:

- The MFSA and the MFIN should develop formal internal crisis management plans as a complement and input to the Interagency Crisis Management Framework.
- The Interagency Crisis Management Framework should eventually address how the domestic agencies would interact with European authorities in the event of a system-wide crisis, potentially involving other euro area jurisdictions, to ensure financial stability in Malta.