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MALTA

FINANCIAL SECTOR ASSESSMENT PROGRAM

November 2019

TECHNICAL NOTE—INSURANCE AND SECURITIES SECTOR SUPERVISION

This Technical Note on Insurance and Securities Sector Supervision 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 2019.

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November 6, 2019

TECHNICAL NOTE

INSURANCE AND SECURITIES SECTOR SUPERVISION

Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared by an IMF external 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, IMF. 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 can be found at http://www.imf.org/external/np/fsap/fssa.aspx.

CONTENTS

Glossary

AIF	Alternative Investment Fund
AUM	Asset under Management
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
CBM	Central Bank of Malta
CEO	Chief Executive Officer
CIS	Collective Investment Scheme
CSU	Conduct Supervision Unit
DG	Director General
DIF	Domestic Investment Fund
ECB	European Central Bank
EIOPA	European Insurance and Occupational Pensions Authority
ESA	European Supervisory Authority
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
ETF	Exchange Traded Fund
EU	European Union
EWSM	European Wholesale Securities Market
FIAU	Financial Intelligence Analysis Unit
FI	Financial Institution
FinTech	Financial Technology
FM Act	Financial Markets Act
FST	Financial Services Tribunal
FTE	Full-Time Equivalent
GDP	Gross Domestic Product
GWP	Gross Written Premium
IA Act	Insurance Intermediary Act
IAU	Internal Audit Unit
IB Act	Insurance Business Act
IB(GPS)R	Insurance Business (General Provisions of Supervision) Regulation
IFSM	Institutional Financial Securities Market
IOSCO	International Organization of Securities Commissions
IPSU	Insurance & Pension Supervision Unit
IS Act	Investment Services Act
ISA(SR)R	Investment Services Act (Supervisory Review) Regulation
JFSB	Joint Financial Stability Board
MCR	Minimum Capital Requirement
MFI	Monetary Financial Institution
MFIN	Ministry of Finance
MFSA	Malta Financial Services Authority

MiFID	Markets in Financial Instruments Directive
MoU	Memorandum of Understanding
MSE	Malta Stock Exchange
NAV	Net Assets Value
NCA	National Competent Authority
NFC	Nonfinancial Corporation
ORSA	Own Risk and Solvency Assessment
PCC	Protected Cell Company
PIF	Professional Investment Fund
RAF	Risk Assessment Framework
RBSF	Risk-Based Supervision Framework
RDU	Regulatory Development Unit
RMS	Risk Monitoring System
ROC	Registry of Companies
RQC	Risk Quantitative Criteria
SCR	Solvency Capital Requirement
SMSU	Securities Market Supervision Unit
SPV	Special Purpose Vehicle
SRP	Supervisory Review Process
TCR	Total Composite Risk rating
TIR	Total Impact Rating
TPR	Total Probability Rating
UCITS	Undertakings for the Collective Investment of Transferable Securities
UK	United Kingdom
ULP	Unit-Linked Policy
US	United States
YoY	Year-on-Year

EXECUTIVE SUMMARY

The insurance sector in Malta is relatively large and sophisticated. The sector has grown significantly since Malta's accession to the European Union (EU) in 2004, and its total assets amounted to €11.9 billion (105 percent of gross domestic product (GDP)) at end-2017. Its sophisticated structure is evidenced by the presence of four professional reinsurers, eight captive insurers, 14 protected cell companies (PCC), and one reinsurance special purpose vehicle (SPV). The life insurance and reinsurance industries are highly concentrated.

Except for the eight domestic insurers, Maltese insurers wrote predominantly or exclusively non-Maltese risks, mainly in other EU member states. Three banks are enrolled as tied insurance intermediaries to distribute insurance products manufactured by related insurers and/or third-party insurers. Some Maltese insurers who passport their business to other EU member states contract with managing general agents with delegated authority for distribution or other ancillary services.

There are 688 investment funds in Malta, with a total net asset value (NAV) of €10.8 billion as of end-2017 (96 percent of GDP), of which resident investors owned €2.3 billion. The NAV of Undertakings for Collective Investment of Transferable Securities (UCITS) passported into Malta was circa €265 billion as of December 31, 2017. The top three domiciles of these funds were Ireland, Luxembourg, and the United Kingdom (UK).

The securities sector was well served by 163 investment services licensees as of June 2018. There were 69 fund managers, 26 fund administrators, and 11 custodians servicing the funds industry, and another 94 firms regulated under the Markets in Financial Instruments Directive. Although 37 firms have notified the Malta Financial Services Authority (MFSA) of their intention to passport their services out of Malta, only 24 firms have done so. The total market capitalization of the Malta Stock Exchange (MSE) was €12.2 billion as of end-2017.

As the single regulator responsible for the regulation and supervision of financial services in Malta, the MFSA has a broad mandate. Specifically, the MFSA's prudential and conduct supervision and related regulatory developments of the insurance and securities sectors cover the following entities as of end-March 2018:

- 65 (re)insurers, one reinsurance SPV, 11 insurance managers, 16 insurance agents, 32 insurance brokers, 459 tied insurance intermediaries, 16 retirement scheme administrators, 51 retirement schemes, two retirement funds, 12 investment managers, and eight back-office administrators;

- 162 investment intermediaries, 688 investment funds, 26 fund administrators, regulated market infrastructures, supervision of listing requirements, processing of securitization notifications and market surveillance, development of a regulatory framework for initial coin offerings, virtual financial assets, and related service providers; and

- 27 insurance groups and two financial conglomerates.

The legal powers and supervisory objectives of the MFSA are clear and in line with international standards. The MFSA has adequate legal authority to discharge its supervisory responsibilities and to take the necessary preventive and corrective measures to protect the public interest. Clearly established legal gateways for information sharing facilitate supervisory coordination and cooperation between the MFSA and relevant supervisors/authorities, domestically and internationally. For the avoidance of doubt, the MFSA has proposed amending the MFSA Act to explicitly include the promotion of financial stability and financial market integrity as one of its key functions.

The MFSA is governed by the Board of Governors and is subject to public accountability policy and mechanisms. The appointment and dismissal of the Chairman and the Governors are provided under the MFSA Act. The MFSA has established an Ethics Framework, while its *Staff Handbook* sets out clear rules on managing conflicts of interest by staff members and the Governors. The Audit Committee provides independent assurance to the Board on the governance and risk management of the MFSA and oversees the Internal Audit Unit (IAU). Established in November 2016, the IAU is working on filling its approved headcount to achieve its audit objectives. The MFSA reports to the parliament on an annual basis, regularly consults the public on regulatory changes, and provides comprehensive information on its website. Appeals against the MFSA's decisions may be made to the Financial Services Tribunal, whose decisions may be appealed to the Court of Appeals on a question of law.

There is a compelling need to address the severe gap in supervisory capacity as an immediate priority. The implications arising from this severe gap in supervisory resources have been highlighted by external independent reviewers and the IAU. The MFSA has estimated that a staff complement of 450 (an increase of 150 over the current level) would be required by 2021 to cater for growth in the financial services sector and to regulate emerging sectors. The MFSA is fully cognizant of the resource challenges and has proposed redesigning its remuneration system to help attract and retain talent. It has also embarked on a branding exercise to position itself as the employer of choice while enhancing its recruitment strategy.

Stable funding and full autonomy over the recruitment process are needed to support the MFSA's operational and financial independence. While the MFSA's funding has been sufficient and stable in the past, funding shortfalls are forecasted over the next five years—largely due to the loss of revenue from the separation of the Registry of Companies (ROC)—and plans to significantly increase supervisory resources. To ensure stable funding, the government should provide strong public commitment to a five-year funding plan. The MFSA should also be exempted from the recruitment policy and procedures applicable to public-sector entities so that the MFSA can better attract and retain supervisors of high caliber.

The Board of Directors, organs of the MFSA, its officers, and employees must safeguard the official confidentiality, and they do have adequate legal protection. A breach of confidentiality can lead to a dismissal without notice. This confidentiality obligation also applies to former officers and employees of the MFSA, as well as to inspectors, auditors, and experts acting on behalf of the

MFSA. The MFSA, members of its Board of Governors, and its officers and employees have legal protection for the exercise of their official duties except for omissions or for acts done in bad faith.

There are various coordination and cooperation mechanisms and platforms between the MFSA and relevant domestic and international authorities. The MFSA maintains close working relationships with relevant regulators in other EU member states in order to perform their respective supervisory roles under the EU passporting regime. There is a Memorandum of Understanding (MoU) with the Central Bank of Malta (CBM) pertaining to financial services, as well as payment and securities settlement systems. The CBM, the MFSA, and the Ministry of Finance (MFIN) have jointly set up a Crisis Management Committee and executed a MoU to coordinate the prevention and management of financial crises. The MFSA cooperates closely with the Financial Intelligence Analysis Unit (FIAU) on anti-money laundering and combating the financing of terrorism (AML/CFT) supervision. The MFSA has also signed bilateral MoUs with EU and third-country supervisors, and it is signatory to a number of multilateral MoUs established by international standard setters.

Recognizing the scope for harmonizing and enhancing the current sectoral risk-based supervision frameworks (RBSF), the MFSA is developing an integrated RBSF. The RBSF for the insurance sector assesses (re)insurers based on their risk impact and the probability of risk, which drive the annual supervisory plan. The MFSA acknowledges that the monitoring of macro risks and insurance business model analysis could be better embedded in the RBSF. Similarly, the RBSF for the investment firms evaluates their impact and probability of risks and determines the intensity and focus of supervision. While different quantitative criteria for risks have been tailored to different categories of licensees, they are largely based on financial indicators with less focus on inherent business risks. The move toward an integrated RBSF would allow a harmonized risk-based approach across the financial sector, while taking inputs from the ECB supervision process. Concurrently, the MFSA should formulate a supervisory stance and baseline supervision program for conduct supervision beyond the current supervisory program for investment services companies and continue to build its macroprudential surveillance capabilities for the insurance and securities sectors.

While the implementation of the supervisory plans for the insurance and securities sectors has been affected by stretched supervisory resources, the quality of supervisory assessments appears not to be compromised. Market participants in the insurance and securities sectors interviewed have high regard for the MFSA, but voiced concerns that its supervisory effectiveness may be undermined by inadequate resources. They opined that senior MFSA supervisors have a good understanding of their business models and risks, facilitated by open communication and close dialogue. The MFSA has also established internal procedures and checklists to promote the consistency and effectiveness of supervision. A sample review of supervisory files indicates that the supervisory assessments were satisfactory. Notwithstanding the challenges in resources, there is consensus that the supervisors have demonstrated commitment to fulfill their supervisory accountabilities, albeit having to make difficult compromises on the prioritization of competing demands on the limited supervisory resources.

The key recommendations are summarized in the table below.

Key Recommendations	Institution	Priority
Supervisory Resources and Independence		
1. Ensure stable funding for the MFSA by providing strong public commitment to a five-year plan to increase its budgetary resources.	Government	High
2. Grant the MFSA full autonomy over its recruitment process by exempting it from the recruitment policies and procedures applicable to public-sector entities.	Government	High
3. Address the significant gap in supervisory capacity as an immediate priority.	MFSA	High
4. Ensure that the IAU is adequately resourced, including timely recruitment to achieve the approved headcount.	MFSA	Medium
Insurance and Securities Regulation and Supervision		
5. Formulate a clear supervisory stance, including a baseline supervisory program for conduct supervision, particularly for banks acting as distributors of insurance and securities products.	MFSA	High
6. Cultivate the necessary expertise to enable more holistic macroprudential surveillance, with tailored methodology and models that reflect the risk profiles of the insurance and securities sectors.	MFSA, CBM	High
7. Finalize the proposed amendment to the MFSA Act to provide explicit clarity on the MFSA's key functions to promote financial stability and financial market integrity.	Government	Medium
8. Finalize the ongoing initiative to improve and harmonize the MFSA's risk-based supervision framework.	MFSA	Medium

OBJECTIVE AND SCOPE

1. **This Technical Note reviews the institutional arrangement and supervisory practices for the insurance and securities sectors in Malta, focusing on supervisory effectiveness.**[1] The review covers the governance, powers, operational independence, and supervisory resources of the MFSA. The evaluation is benchmarked against the relevant Insurance Core Principles established by the International Association of Insurance Supervisors, and the Objectives and Principles of Securities Regulation promulgated by the International Organization of Securities Commissions (IOSCO). The scope of review for the securities sector is limited to investment funds and securities firms.

2. **An effective supervisor is one who is both able and willing to act.** The *ability* to supervise hinges on a clear mandate, robust governance, and adequate supervisory capacity as well as good coordination and cooperation with other relevant agencies. This must be complemented by the *willingness* to take timely and effective supervisory actions, pose constructive challenges to regulated entities, question group think, and make tough decisions without fear or favor. In essence, an effective supervisor is operationally independent with appropriate accountability, adequately resourced, and respected for technical leadership and professional integrity.

3. **The review is largely based on the MFSA's comprehensive responses to a tailored questionnaire, technical discussions with relevant authorities, and interviews with selected industry participants.** The Reviewer is grateful for the full cooperation extended by the authorities, particularly their thoughtful coordination of the industry meetings.

MARKET OVERVIEW AND KEY TRENDS

A. Insurance Sector

4. **Malta has a developed and stable insurance market structure, with total assets representing 105 percent of GDP as of end-2017 (Table 1).** Assets held by insurers amounted to 14 percent of financial sector assets as of end-2017.[2] There were 51 direct insurers[3] as of end-2017,

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[1] Prepared by Su Hoong Chang, an IMF external regulatory expert. The review was conducted during the period of September 10–16, 2018, and considers the legal and regulatory framework in place and the supervisory practices employed at the time. The review did not cover the regulation and supervision of virtual assets.

[2] The ratio is derived from excluding assets held by Captive Financial Institutions and Money Lenders (CFIML); including the CFIML assets, the ratio is 4 percent.

[3] Includes 14 PCCs. The PCC has two parts: (a) a **core,** which maintains and controls the PCC; and (b) a number of **cells**, each with its own share capital. The income, assets, and liabilities of each cell are segregated from those belonging to other cells and the core of the PCC. While each cell does not have a separate legal entity, it is protected or ring-fenced through segregation, i.e., creditors may only have recourse to the cellular assets attributable to the cell(s) they have transacted with. In the event of a solvency shortfall, a cell may have recourse to the core to meet liabilities when its assets are exhausted. However, a cell carrying on captive insurance business or restricted to write reinsurance only is permitted to enter into a nonrecourse agreement.

of which two composite insurers were licensed/grandfathered to write both life and non-life insurances, as no new composite insurers were admitted after 1998. The market structure is sophisticated, as evidenced by the presence of four professional reinsurers, eight captive insurers,[4] 14 PCCs, and one reinsurance SPV. Further analysis of the industry's asset distribution can be found in Table 4.

Table 1. Insurance Market Structure

Types of Insurers	2013		2017		*Change*		
	No	Assets (€mln)	No	Assets (€mln)	No	Assets (€mln)	Percent
Life insurer	6	2,150	6	4,135	0	1,985	91
Non-life insurer	27	1,633	29	3,797	2	2,164	133
Composite insurer	2	NA[1/]	2	NA	0		
Reinsurer	4	5,771	4	2,832	0	-2,939	-51
Captive insurer	8	446	5	435	-3	-11	-2
Captive reinsurer	3	77	3	149	0	72	94
PCC (non-life)	9	190	12	479	3	289	152
PCC (life)	1	22	2	23	1	1	5
Reinsurance SPV	0	0	1	0	1	0	
	60	10,289	64	11,850	4	1,561	15
Nominal GDP		7,642		11,295			
Total assets/GDP (percent)		135		105			

Sources: MFSA and CBM.

[1/] The assets of composite insurers have been allocated under non-life to reflect the dominant portfolios.

5. Malta's accession to the EU has contributed to the strong growth of the insurance sector over the last decade. The sector's gross written premium (GWP) grew from circa €250 million as of end-2004 to reach €4.2 billion as of end-2017. Passporting through freedom of services or freedom of establishment has facilitated mutual market access between insurers in Malta and other EU states.

6. The penetration and density rates[5] calculated based on GWP of domestic risks understate the stage of development of the Maltese insurance sector. Excluding GWP in respect of foreign risks, the insurance penetration and density rates of Malta are below the average penetration of advanced economies, as indicated in Box 1, with scope for further growth, particularly in non-life insurance. However, more than 90 percent and 70 percent of non-life GWP and life GWP in 2017, respectively, related to risks outside of Malta, as shown in Table 3. Notably, 30 of the 35 direct insurers, all four reinsurers, and the eight captive insurers, as well as 13 PCCs, wrote predominantly or exclusively non-Maltese risks.

[4] A captive (re)insurer provides insurance cover exclusively for the risks of the parent or other associated companies within the group. Under EU laws, a captive cannot be owned by a re(insurer) or an insurance group.

[5] Penetration rate is measured by GWP as a percentage of GDP, while insurance density is GWP per capita.

Box 1. Global Insurance Market, 2017

	GWP	Insurance Density		Insurance Penetration	
	US$ billions	Life	Non-life	Life	Non-life
Advanced market	3,820	1,899	1,618	4.2	3.6
Global Share (percent)	*78*				
Emerging markets	1,072	92	73	1.9	1.5
European Union	1,358	1,455	975	4.3	2.9
Global Share (percent)	*28*				
World	4,892	353	297	3.3	2.8
Malta	***4.7***	***887***	***364***	***3.2***	***1.3***

Source: Swiss Re – World Insurance in 2017, Sigma 3/2018.

7. **The life insurance and reinsurance industries are highly concentrated.** The top five life insurers accounted for more than 98 percent of the market share, of which the top two life insurers had 85 percent share in 2017. The reinsurance industry is dominated by two companies, with the larger writing 84 percent of reinsurance premiums in Malta and the second writing 7 percent. The non-life industry is less concentrated, with about 54 percent of GWP written by the top five non-life insurers.

8. **The authorities have identified eight "domestic insurers," whose assets totaled €4.1 billion as of end-2017, or 36 percent of GDP.**[6] The CBM uses four indicators[7] to identify domestic insurers deemed to have significant links with the domestic economy. The four indicators, which are weighted equally, are: (a) shareholding by core domestic banks; (b) resident investment assets;[8] (c) total GWP for risks situated in Malta; and (d) total gross claims paid for risks situated in Malta. The domestic insurers as of end-2017 are listed in Table 2. The domestic insurers reported profitable operations in 2017, with combined return on assets and return on equity of 1.3 percent and 13 percent, respectively, higher than EU medians (0.4 percent and 7 percent, respectively).[9,10]

[6] Insurers are grouped into two categories, domestic and international. The CBM's systemic risk monitoring covers domestic insurers only (see paragraphs 111–114 on macroprudential surveillance). Domestic insurers are given higher weights under the current RBSF.

[7] The indicator of each insurer is divided by the maximum level of each category to standardize the variables, such that the relative sizes are preserved and are independent of the measurement unit. The standardized indicators within each category are added to give one score per insurer.

[8] Resident investment assets include bonds (government bonds, corporate bonds, collateralized debt securities, and structured notes) and equity (equity and participations in collective investment undertakings).

[9] Source: EIOPA Risk Dashboard (April 2018).

[10] The high profitability relative to the EU may be contributed to the dominance of domestic life insurers, which write mainly participating business and invest locally, unlike most foreign insurers.

Table 2. Domestic Insurers, end-2017[1/]

Life Insurers	Non-life Insurers
MAPFRE MSV Life plc *(51 percent)*	MAPFRE Middlesea plc *(3 percent)*
HSBC Life Assurance (Malta) Limited *(33 percent)*	Citadel Insurance plc *(1 percent)*
Global Capital Life Insurance *(3 percent)*	Elmo Insurance Limited *(1 percent)*
	Gasan Mamo Insurance Malta *(1 percent)*
	Atlas Insurance PCC Malta *(3 percent)*

1/ Numbers in parentheses denote share of total assets as of end-2017.

Sources: MFSA and CBM.

9. **Malta is the only EU member state that has established PCC corporate structure for insurance operations, and all except one PCC wrote business predominantly throughout EU through passporting.** There were 14 PCCs (34 cells) as of end-2017, four more than the 10 PCCs (22 cells) in 2013. Each cell in the PCC is segregated from the other cells within the PCC. The PCC structure is typically used by small- and medium-size companies to leverage on the centralized governance and services offered by the core. Nine out of the 14 PCCs were licensed to write general liability class of business, and one PCC wrote mandatory motor third-party liability risks.[11]

10. **Insurers in Malta use a diversified range of insurance intermediaries for product distribution or insurance management services.** As of end-2017, there were 16 enrolled agents, 31 enrolled brokers, 11 enrolled insurance managers, as well as 474 tied insurance intermediaries. Three core domestic banks—Bank of Valletta, HSBC Bank Malta, and APS Bank Ltd.—are enrolled as tied insurance intermediaries to distribute insurance products manufactured by related insurers and/or third-party insurers through their network of bank branches in Malta. Some Maltese insurers who passport their services to other EU member states contract with managing general agents with delegated authority for distribution or other ancillary services.

Operating and Financial Performance

11. **GWP of direct non-life insurers registered an average year-on-year (YoY) growth of 17 percent over the past five years.** In 2017, motor insurance had 28 percent market share, followed by property insurances (24 percent). A few insurers specialized in run-off business, i.e., acquiring insurers' legacy portfolios and offering tailored transactions to help clients achieve finality and capital relief, enabling them to focus on their core business (Table 3).

[11] One PCC writes direct motor third-party liability business through the core and through a cell. Another PCC writes reinsurance business through a cell. Although nine PCCs are authorized to write general liability, only four currently write this business—one on a direct basis and the rest through reinsurance.

12. More than 90 percent of non-life GWP in 2017 was sourced from foreign risks[12] through passporting to other EU members (Table 3). The top four non-life insurers wrote business mainly outside of Malta. One of them adopted an EU cover-holders business model,[13] with delegation of underwriting and claims within predefined parameters. Two insurers offered mainly payment protection insurance related to the financing of motor vehicle purchases for customers of finance companies within their respective groups. The remaining insurer provided a program of insurance cover to its group holding company and associated companies as well as third-party risks (mainly handsets insurance).

13. GWP of direct life insurance industry has increased by an average of 19 percent YoY over the past five years, with the top two insurers having more than two-thirds market share. About 58 percent of GWP was attributable to domestic risks[14]; of which 83 percent came from with-profits or participating policies. Participating policies provides both guaranteed and non-guaranteed benefits.[15] For the discretionary non-guaranteed benefits, life insurers are expected to meet policyholders' reasonable expectation in estimating the technical provisions for participating policies, which should be supported by clear governance arrangements for the allocation of profits between policyholder and shareholders.[16] Both MAPFRE MSV Life plc and HSBC Life Assurance (Malta) operate domestically, offering mainly protection and with-profits policies.

14. GWP of reinsurers in 2017 totaled €1.9 billion, of which proportional premiums were €1.1 billion (58 percent), with the remaining premiums from non-proportional business. According to the European Insurance and Occupational Pensions Authority (EIOPA) analysis, Malta had the highest share of reinsurance premiums as a proportion of total GWP in Q4 2017. This was mainly attributable to reinsurance business of the subsidiaries of large EU (re)insurance groups in Malta. All the reinsurers in Malta are part of international groups.

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[12] Domestic **non-life** risks relate to policies where the insureds are residents in Malta. All other risks are considered as foreign risks.

[13] Cover-holders act as agents for insurers, writing insurance contracts on their behalf and serving as their local representatives. Cover-holders enable insurers to extend their geographic reach by benefiting from local knowledge of risks and market conditions.

[14] Domestic **life** risks relate to risks located in Malta or where the insureds are Malta residents or have permanent establishments in Malta.

[15] The sum assured is a guaranteed benefit and is paid when the policy matures or upon the death of the insured. Participating policyholders are allowed to participate or to share in the profits of an insurer's participating fund, typically paid in the form of bonuses or cash dividends.

[16] The reasonable expectations of policyholders will depend on the types of policy, the practice of the insurer, the manner in which benefits are presented to policyholders, and the expectations created by marketing materials. In this regard, international best practices call for clear and explicit governance arrangements, including policies and practices for distributing discretionary bonuses and proper disclosure of the parameters for exercising discretion such as the methodology to calculate emergence of surplus; allocation of profits between policyholders and shareholders; the approach adopted for smoothing the discretionary benefits; and managing conflicts of interest between policyholders and shareholders, as well as between different generations of policyholders. The MFSA has not issued guidance on insurers' governance arrangement for with-profits policy.

Table 3. Analysis of Gross Written Premiums, 2017[1/]

(in millions of euros)

	Domestic	Foreign	Total	Market Share Percent
Non-life				
Motor	83	380	463	28
Property	32	370	402	24
Liabilities	9	96	105	6
Accident and Health	13	114	127	8
Others	16	539	555	34
Subtotal	153	1,499	1652	100
Life				
Health insurance	-	15	15	2
With profits/participation	324	-	324	48
Index-linked and unit-linked	35	-	35	5
Others	31	264	295	44
Subtotal	390	279	669	100
Total	543	1,778	2,321	

Source: MFSA.

[1/] Reinsurance is not included.

15. **While total assets in the insurance sector have increased by only 15 percent since 2013, there has been significant change in the distribution of assets across industries (Table 4).** The non-life industry recorded the highest growth in assets of 129 percent over the past five years, with consistently strong growth during 2014–16 that tapered off in 2017. Assets held by life insurers almost doubled; the bulk of which (70 percent) was registered in 2014, mainly attributable to an increase in investments supporting unit-linked policies (ULPs).[17] In contrast, reinsurers' assets dropped by half due to the termination of one block of business by a large reinsurer in 2016.

[17] Under ULPs, the investment risks are typically passed on to policyholders, i.e., policyholders may receive less than the premiums in the event of a market distress.

16. The reported solvency position of the insurance industry is healthy (Table 5). The average solvency capital requirement (SCR)18 ratio for life and captive insurers was above 200 percent, while reinsurers' own fund was five times more than the SCR as of end-2017. Although two entities were in breach of the minimum capital requirement (MCR)[19] as of December 31, 2015, both rectified the shortfall promptly.

Table 4. Insurers' Asset Portfolios, end-2017[1/]

(in millions of euros)

	Life	Non-life	Reinsurance	Captives	Total	*Percent*
Intangible assets	135	13	235	-	383	*3.2*
Government and Corporate securities	1,187	1,504	1,990	79	4,706	*40.2*
Equities	927	351	32	75	1,386	*11.7*
Real estate and real-estate related	108	52	3	-	163	*1.4*
Cash and bank balances	526	704	369	79	1,678	*14.2*
Investments supporting ULPs	1,003	NA	NA	NA	1,003	*8.5*
Receivables	12	275	220	46	553	*4.7*
Intragroup/-related company receivables	41	186	26	174	427	*3.6*
Reinsurance recoverables	179	845	32	129	1,185	*10.0*
Other assets	35	252	15	11	313	*2.6*
Total	**4,153**	**4,182**	**2,922**	**593**	**11,850**	*100.0*
Total assets as of end-2013	2,172	1,823	5,848	446	10,289	
Increase/decrease (percent)	*+91*	*+129*	*-50*	*+33*	*+15*	

Source: MFSA.

[1/] Total assets as reported under IFRS. Based on the Solvency II framework methodology, the sector's total assets amounted to €10.7 billion at end-2017.

[18] The SCR is calibrated at a 99.5 percent value at risk (that (re)insurers can meet their obligations to policyholders and beneficiaries) over the next 12 months. If an insurer or reinsurer is not complying with the SCR, it has to take measures (increasing capital or lowering risk) to meet the SCR within six months.

[19] The MCR represents the minimum level of capital that (re)insurers are required to hold. It is set at an 85 percent confidence level that a (re)insurer will be able to meet its obligations over the next 12 months. The MCR is bounded between 25 percent and 45 percent of the SCR. A breach of the MCR could result in a withdrawal of authorization unless it is covered again in three months.

Table 5. Solvency Position of Insurers
(end of period, in percentage)

	2015	2016	2017
Own Funds over MCR			
Life	673	694	649
General	625	586	444
Reinsurance	1108	1097	1077
Captive	597	683	775
Own Funds over SCR			
Life	275	273	257
General	236	209	175
Reinsurance	502	497	488
Captive	162	185	219

Source: MFSA.

B. Securities Sector

17. Since 2013, the securities sector has been one of the fastest growing segments within Malta's financial services sector. This segment also saw significant EU regulatory changes in recent years, such as the Markets in Financial Instruments Directive II (MiFID II),[20] Alternative Investment Fund (AIF) Managers Directive and Undertakings for the Collective Investment of Transferable Securities Directive (UCITS V),[21] which catalyzed structural changes in the market profile.

Investment Funds

18. Investment funds have been growing steadily, albeit with a clear shift in market profile. There were 688 funds with NAV totaling €10.8 billion as of end-2017 (Table 6).[22] The funds industry accounted for 96 percent of GDP and 14.8 percent of total financial sector assets. AIFs and professional investor funds (PIF) are the most popular fund types, accounting for 74 percent of the total NAV.[23] Concurrently, the market also saw a move toward UCITS funds, with a corresponding decline of non-UCITS retail funds as the regime for these funds is being phased out. The foreign-based funds were non-EU-domiciled funds that had been reclassified as third-country AIFs under

[20] Directive 2014/65/EU of the European Parliament and of the Council of 15th May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

[21] Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations, and administrative provisions relating to undertakings for collective investment in transferable securities as regards depositary functions, remuneration, and sanctions.

[22] The ratio is derived from excluding assets held by *Captive Financial Institutions and Money Lenders* (CFIML, sector 127 of the European System of National and Regional Accounts, ESA 2010). Including the CFIML assets, the ratio is 4.2 percent.

[23] Some PIFs were reclassified as AIFs in response to regulatory changes.

the National Private Placement Regime. Notified AIFs, which are subject to indirect supervision through the fund managers and were introduced in 2016, had a slow star.

Table 6. Investment Funds

(in millions of euros, end-year)

	2013		2017		*Change*	
	No	NAV	No	NAV	*No*	*NAV*
		€ millions		*€ millions*		*€ millions*
Alternative investment funds	0	-	101	3,325	*101*	*3,325*
Professional investor funds	509	6,406	450	4,701	*-59*	*-1,705*
UCITS CIS	70	2,293	114	2,714	*44*	*421*
Non-UCITS CIS	21	712	5	7	*-16*	*-705*
Notified AIFs	0	-	18	56	*18*	*56*
Foreign	16	735	0	-	*-16*	*-735*
Total	**620**	**10,147**	**688**	**10,804**	*75*	*657*

Source: MFSA.

19. Nonresident investors own the bulk of the total NAV, amounting to €8.5 billion, or 75 percent of GDP. Resident investors own €2.3 billion of the total NAV (20 percent of GDP). Holdings of resident households represented only about 3.5 percent of total household wealth, suggesting the exposure of Malta residents to the funds industry is limited. Investments by monetary financial institutions (MFI) and nonfinancial corporations (NFC) accounted for 10 percent and 23 percent of the NAV, respectively. Such investments represented less than 3 percent of total financial assets for both MFIs and NFCs in Malta.[24]

20. In 2017, the MFSA authorized 97 new collective investment schemes (CIS), while 78 CISs surrendered their licenses voluntarily. The newly authorized CISs included 58 PIFs, 30 UCITS funds, and nine AIFs. The surrenders were 49 PIFs, 12 AIFs, 10 UCITS funds, three foreign-based funds, two retail non-UCITS funds, one notified AIF, and one recognized private CIS.

21. As of end-June 2018, there were 69 fund managers, 26 fund administrators, and 11 custodians servicing the funds industry. Notably, 25 local fund managers manage 94 funds in 11 EU and other third countries. The top five fund managers accounted for 51 percent of total asset under management (AUM) as of end-2017, and they mainly managed funds domiciled in the Cayman Islands. The number of custodians has remained stagnant at 11 since 2015, which is viewed as one of the key factors for the slow growth of the funds industry in Malta.

22. About 88 percent of the funds (590) were administered in Malta, with another 167 non-Malta-domiciled funds (NAV €0.5 billion) administered in Malta. Self-managed

[24] Source: 2019 FSAP, General Questionnaire for Vulnerability Assessment.

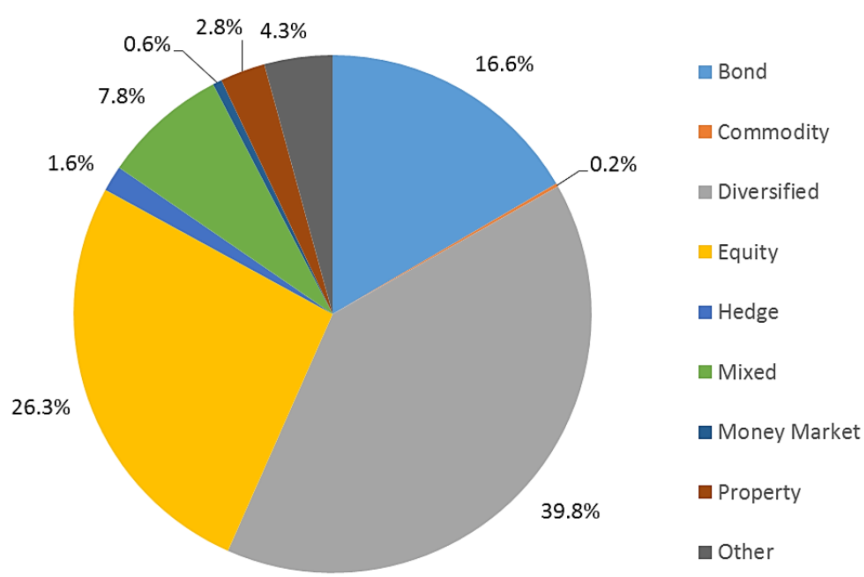
funds[25] accounted for almost 34 percent of funds, while another 30 percent of funds were managed by local fund managers. Another 27 percent of the funds were managed from outside Malta.

23. Funds established as multi-funds were most popular, followed by standalone and master-feeder structures. As of December 2017, 81 percent of the CISs operated using a multi-fund structure, 16 percent as standalones, while about 3 percent were master-feeder structures.

24. Generally, the domestic investment funds (DIFs)[26] are considered low investment risk. There were 46 DIFs with NAV totaling €1.8 billion as of December 2017. More than 60 percent of the DIFs were UCITS funds, and most DIFs are not permitted to use borrowing except temporarily, and it cannot exceed 15 percent of total assets. DIFs also invested mainly in bonds, accounting for 67 percent of AUM as of December 2017, of which more than half consisted of Malta government securities and the rest was mainly held in corporate bonds. The corporate bond issuers were mainly foreign and domestic NFCs, captive financial institutions and banks. Equity holding in MFIs formed the remaining 17.7 percent of AUM of DIFs.[27]

25. Diversified funds[28] had the largest share of NAV (40 percent or €4.3 billion), followed by equity funds (26 percent) and bond funds (17 percent) as of end-2017 (Figure 1).

Figure 1. Investment Funds—Net Asset Value by Asset Allocation, 2017



Source: Analysis of CIS licensed by the MFSA (2017).

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[25] Investment management is conducted via in-house Investment Committee under the oversight of the Board of Directors.

[26] Funds where residents hold more than 50 percent of NAV.

[27] Source: 2019 FSAP, General Questionnaire for Vulnerability Assessment.

[28] Funds that invest in more than two asset classes.

26. Through passporting, 308 UCITS funds, 75 AIFs, and 44 EU AIFs licensed as venture capital funds have submitted notifications to market in Malta as of September 2018. As of December 31, 2017, the total NAV of other European UCITS passporting into Malta was circa €265 billion. The top three EU domiciles where the funds were passported from are Ireland, Luxembourg, and the UK. The MFSA did not have information on the investor profile.

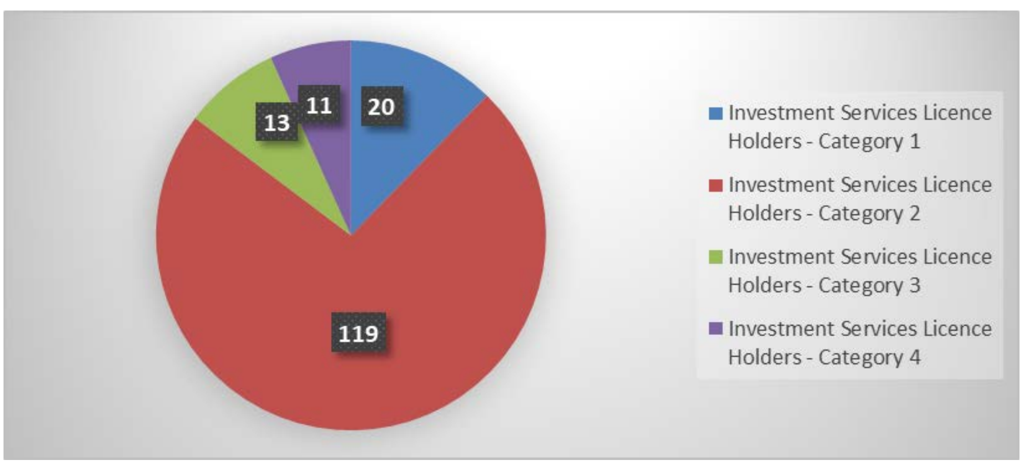
Investment Intermediaries

27. Of the 163 investment services licensees as of June 2018 (Figure 2), 69 are fund managers and 94 are regulated MiFID firms (including 11 custodians).[29] Category 1 licensees are authorized to receive and transmit clients' orders and to provide investment advice. Category 2 firms may hold or control client money/assets, execute and provide portfolio management services in addition to the activities permitted under Category 1, while Category 3 licensees are allowed to trade for their own account. The Category 4 license is for trustees or custodians of CISs. Of the 94 regulated firms, 55 have been licensed to provide products and services to retail clients, although only 43 have done so.

28. While 37 firms have notified the MFSA of their intention to passport their services out of Malta, only 24 firms have done so. The top three jurisdictions where these firms' passport to were Germany, Italy, and the UK. One European investment firm has established a branch in Malta.

29. Trading on own account by investment firms has been limited. Only 13 firms holding a Category 3 license may conduct proprietary trading, of which five firms derive significant revenue from such trading. Revenues from proprietary trading amounted to only 16 percent of the total revenues of all investment firms (excluding banks and fund managers).

Figure 2. Investment Intermediaries by Category of License, June 2018



Source: MFSA.

[29] The 94 regulated MiFID firms include eight licenses that are in suspension or under appeal. Of the 11 Category 4 licenses, seven firms also hold a Category 2 license, while two firms hold a Category 3 license.

Trading Venues[30]

30. At the time of review, the MSE was the only market operator in Malta. It commenced operations on January 8, 1992, and currently offers a comprehensive range of back-office services besides admission to trading and secondary trading activities. These back-office services include maintenance of share and bond registers, clearing and settlement, and custody services through its Central Securities Depository. There are currently 17 members on the MSE. The total market capitalization of the MSE at end-2017 was €12.2 billion; the exchange comprised 23 equity issues (€4.3 billion), 63 bond issues (€1.7 billion), and 50 Maltese government securities issues (€6.1 billion). Market turnover was thin, with trading volume totaling only €0.6 billion in 2017, of which equity turnover was €88 million. There is no high-frequency trading, no market makers, no direct market access, or short-selling on the MSE. Admission to listing on the regulated market operated by the MSE is subject to the prior approval from the Listing Authority (i.e., the Board of Governors of the MFSA). Although 29 DIFs were listed on the MSE, these were not traded on the exchange.

31. While growth of the mainboard has been constrained by limited listings, the MSE continues to diversify its operations. In February 2016, the MSE launched the Prospects multi-trading facility (MTF) for small and medium enterprises to raise funds by issuing bonds or equity.[31] In 2017, the market capitalization of Prospects reached €15 million but annual turnover was thin at €0.2 million. In October 2016, the MSE launched the National Capital Markets Strategic Plan, aimed to develop a liquid and efficient securities market. In September 2017, the MSE introduced a third market, the Institutional Financial Securities Market (IFSM), the first fully Maltese institutional securities market.[32] The MSE also plans to introduce exchange traded funds (ETFs)[33] to its platform.

32. The market capitalization of MSE is highly concentrated in instruments issued by the financial sector. At end-2017, four banks were listed on the MSE, together with GlobalCapital plc, (a holding company with businesses in investment, insurance, and property) and Mapfre Middlesea plc (a domestic insurer). These six companies accounted for almost half the equity market capitalization on the MSE at end-2017. In addition, the outstanding bonds issued by five banks, GlobalCapital plc, and Gasan Finance Company plc accounted for almost 30 percent of the total bonds listed on the MSE.[34]

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[30] Under MiFID II, the term "trading venues" encompasses regulated markets, multilateral trading facilities, and organized trading facilities.

[31] Companies considering admission to Prospects MTF require the services of a corporate advisor prior to and following the admission process.

[32] The IFSM is specifically designed for the institutional investors. The minimum denomination of financial instruments quoted on the IFSM is €100,000. The types of instruments that are admissible to the IFSM are: debt securities, asset-backed securities, insurance-linked notes, convertible debt securities, and derivative securities.

[33] ETFs are open-ended investment funds listed and traded on a stock exchange. An ETF typically aims to produce a return that tracks or replicates a specific index such as a stock or commodity index. Such index-tracking ETFs are passively managed by ETF managers and do not try to outperform the underlying index, and charge lower fees than those of actively managed investment funds.

[34] See discussion of financial sector interconnectedness below.

33. The small capitalization and thin trading on the MSE pose challenges for institutional investors, with implications for capital market development. The illiquid market is prone to higher price volatilities. Furthermore, fund managers are subject to concentration limits applicable to UCITS funds and face challenges in finding quality local equities or bonds beyond the top few issuers. The local equities and corporate bond markets are driven predominantly by retail investors, who typically buy and hold. The limited options for investment have curtailed the interests of institutional investors, which will have an adverse impact on the long-term sustainable development of the capital markets in Malta. Anecdotally, a number of (re)insurers and investment managers in Malta do not invest in Maltese financial instruments.

34. The European Wholesale Securities Market, which previously operated in Malta, ceased operations on July 31, 2018. Established in February 2012, the EU-regulated market for wholesale debt securities listed corporate and structured bonds with minimum denominations of €100,000. It was a joint venture between the Irish Stock Exchange plc (with 80 percent stake) and the MSE (20 percent share).

C. Key Risks and Vulnerabilities

Insurance Sector

35. The high level of concentration of the life and reinsurance industries has significant implications for the stability of the insurance sector. The top two life insurers accounted for 96 percent of total assets of domestic life insurers and 85 percent of the GWP of the industry. The largest reinsurer accounted for 84 percent of reinsurance premiums in Malta.

36. The MFSA is closely monitoring the potential impact arising from a "hard" Brexit. Under this scenario, about 10 insurers who write business in the UK exclusively, while two insurers with more than 50 percent of their business in the UK may decide to cease operations in Malta and establish an entity in the UK. In addition, UK insurers have been writing a substantial volume of health insurance in Malta via passporting of services. Should the UK be considered as a third country, these insurers would either need to operate in Malta via a third-country branch or cease carrying on business in Malta, which may affect consumers' choices. While some insurers have shared their business options with the MFSA, the final outcomes remain fluid at this juncture. The MFSA has proactively engaged all (re)insurers on their Brexit contingency plans.

37. Some insurers' business portfolios lacked diversification to deal with sudden and/or adverse developments. The business models of a number of insurers relied on either selling one insurance product or targeting one particular sector or market. Some other insurers concentrated on one class of business, e.g., 50 percent of the GWP of four of the five domestic non-life insurers came from motor business.

38. The prolonged low-yield environment, with uncertainties arising from a sudden and sharp reversal, is a key risk. The mitigating factor is that life insurers in Malta have a limited exposure to policies with guaranteed returns, which lowers market risks. Recognizing that unfavorable investment returns may motivate some insurers to sacrifice quality in search of higher yields, the MFSA has been monitoring possible shifts in investment risk appetite and did not find any material change. Nonetheless, it would be useful for the MFSA to perform scenario analysis on the impact of interest rates both on insurers' asset portfolios and their technical provisions (via the discount rate used technical provisions). The potential risks of a global repricing of risk premia due to fallout from the ongoing trade war rhetoric and increasing protectionism sentiments is also on the risk radar of the MFSA.

39. The adoption of sophisticated, innovative legal structures and products in Malta presents both opportunities and risks. Globally, many (re)insurers are leveraging on Financial Technology (FinTech) such as blockchain and big data analytics to improve efficiency and customer service. On the other hand, the increased cybersecurity and infringement on customer privacy risks should be carefully managed. Malta is the only EU member state that has adopted the PCC corporate structure, and the legal sanctity of the cell segregation has yet to be tested in the courts. As PCC legislation does not exist in any other EU state, there is a risk that a court outside Malta would not support the segregation provisions of the Maltese PCC legislation. In addition, an injured third party may challenge the concept of cell segregation, taking the legal position that he/she is an involuntary creditor and has not accepted the risks arising from dealing with a PCC as a counterparty.

40. One insurer was liquidated for insolvency over the past five years. Setanta Insurance Company Limited was established in 2007 and was authorized to write motor business, including third-party motor liability cover in Ireland, under freedom to provide services through a network of about 230 brokers. The key causes of its failure were shortfall in the capital required, poor governance, and underestimation of technical provisions. The insurer surrendered its license to the MFSA in April 2014 and a liquidator was appointed. The liquidation process is still ongoing, and a net deficiency of €88.6 million was reported as of end-2017. Compensation for third-party motor claims from the Irish Insurance Compensation Fund or the Motor Insurers' Bureau of Ireland is still pending.[35]

Securities Sector

41. While DIFs are systemically relevant, the potential financial stability impact is low. The 15 umbrella DIFs, i.e., those that mainly transact with residents, held €1.8 billion assets (16 percent of GDP) in December 2017. While resident households represented almost 50 percent of investors in DIFs, this investment constituted merely 3.5 percent of their financial assets. The low level of leverage in these funds further limits their impact on stability.

42. The key exposure of DIFs is market risk, particularly in the prevailing low interest rate environment. As more than 67 percent of the AUM were held in bonds, the DIFs are vulnerable to developments, such as the tapering of the ECB's asset purchase program, accompanied by an

[35] With a recent change in the insurance legislation in Ireland, eligible third-party personal injury claimants will receive 100 percent compensation from the Insurance Compensation Fund, including any necessary and reasonable costs and expenses. Likewise, eligible third-party property damage claimants will receive 100 percent compensation.

interest rate reversal. Equity prices may also respond unfavorably to heightened political uncertainties (e.g., risks of trade wars, US political agenda, Brexit, etc.).

43. In the past five years, one intermediary failed due to a material shortfall of €6.5 million in clients' assets. A director of Maltese Cross Financial Services Limited was charged with several criminal offenses, including fraud, misappropriation, and forgery, that caused the loss of clients' assets.

Interconnectedness[36]

44. No (re)insurers or other financial entities have been designated officially as systemically important financial institutions, and none of the reinsurers is considered domestically relevant.

45. The MFSA had identified 27 insurance groups[37] and two financial conglomerates,[38] at the time of review. The top five insurance groups did not have domestic operations in Malta. In contrast, the two financial conglomerates (Bank of Valletta plc and HSBC Bank Malta plc) operated exclusively in Malta. As of April 2017, Bank of Valletta plc owned 50 percent of MAPFRE MSV Life plc and 31.08 percent of MAPFRE Middlesea plc, while HSBC Bank Malta plc owned 100 percent of HSBC Life Assurance (Malta) Ltd.

46. Strong interlinkages between related entities of insurance groups and financial conglomerates may elevate contagion risks. One life insurer outsourced a significant portion of investments supporting its ULPs to a related fund manager within the group, and this link may pose reputational and legal risks. In addition, the parent bank serves as its key distribution channel and placed material amount of deposits with the parent bank. Another life insurer derived a significant portion of its business from the parent bank. A life insurer and a related non-life insurer held a material amount of deposits with a related bank. In the event of financial distress of the parent or related banks, there will be implications for the operations of these insurers, including a material risk of losing business.

47. The insurance industry has a low level of investment linkages with other domestic financial institutions. As of end-2017, the eight domestic insurers held 2.7 percent of their assets in DIFs. In turn, the DIFs also held negligible investments in domestic insurers—0.6 percent as of March 2017.

48. The link between the DIFs and the domestic financial sector is mainly via the core domestic banks managing 80 percent of the DIFs AUM. The investments are managed by the

[36] See also FSAP Technical Note on Risk Analysis.

[37] Defined as: (a) (re)insurers with **head office in Malta** that participate in at least one (re)insurer or third-country (re)insurer; or (b) (re)insurers whose parent is an insurance holding company or a mixed financial holding company that has its **head office in Malta**.

[38] Defined under the Financial Conglomerates Regulations (Legal Notice 182 of 2013). Essentially, it is a group/subgroup where at least one of the entities has significant activities in the insurance sector and at least one has significant activities in the banking or investment services sector.

banks' subsidiary fund management companies. The authorities consider the contagion impact to be low because the DIFs are separate legal entities, with independent governing bodies and embedded contract features, such as gating mechanisms and liquidity fees, which could limit the amounts an investor can withdraw. The Network Model analysis of selected funds by the MFSA did not indicate any DIF to be highly connected to the domestic financial system. Nonetheless, one cannot preclude the potential contagion impact in an extreme scenario of a crisis of confidence, resulting in high levels of redemption by policyholders of participating life policies or investors of investment funds, and exerting liquidity stress in the market, as evidenced during the global financial crisis during 2007–09.

SUPERVISORY STRUCTURE AND INSTITUTIONAL ARRANGEMENTS

49. It is generally recognized that adequate supervisory powers and resources as well as operational independence are prerequisites for effective supervision. An empowered supervisor has a clear mandate supported by strong technical capacity to make rules, issue guidance, exercise robust supervision, initiate a range of proportionate preventive and corrective measures, and take decisive enforcement actions when necessary. This section evaluates the legal powers, governance, and operational independence of the MFSA. Given the increasing interconnectedness of the domestic and global financial systems, it is also important for supervisors to coordinate and cooperate with relevant supervisors and other authorities to address common issues, both domestically and on a cross-border basis. This calls for a clear and transparent framework for supervisors to exchange information and provide mutual assistance without compromising their obligations to preserve supervisory confidentiality.

A. Current Supervisory Architecture

50. The supervision of the insurance and securities sectors in the EU is the responsibility of the national competent authorities (NCAs), while the European Supervisory Authorities (ESAs) play a key role in rule-setting. The ESAs comprise the EIOPA, the European Securities and Markets Authority (ESMA), the European Banking Authority, and the European Systemic Risk Board (ESRB). The key objective of the ESAs is to improve the functioning of the internal market, including promoting supervisory convergence across NCAs.

51. Currently, the MFSA, the CBM, and the FIAU share responsibilities for the supervision of the financial sector in Malta.

- Established in 2002, the MFSA is the single regulator responsible for the regulation and supervision of financial services in Malta, including banking, insurance, and securities. The MFSA is part of the European System of Financial Supervisors and participates in meetings of the ESAs.

- The CBM is responsible for the financial stability of Malta and has the macroprudential mandate. The MFSA collaborates with the CBM on matters of financial stability through the Joint Financial

Stability Board (JFSB).[39] The MFIN is an observer on the JFSB and holds no voting powers. The work of the JFSB is complemented by ongoing joint technical meetings and technical-level working groups involving the CBM, MFSA, and MFIN staff; and

- The FIAU is tasked with the monitoring and supervision of compliance with the AML/CFT requirements, including imposing administrative sanctions for breaches of AML/CFT obligations, among other functions. The MFSA works with the FIAU as agent in conducting joint AML/CFT supervision of financial services licensee holders.

52. Both the MFSA and the CBM attend the relevant organs of the European Central Bank (ECB) and the ESRB relating to macroprudential policy and financial stability, including the ESRB General Board, the ESRB Advisory Technical, and the ECB Financial Stability Committee, as well as the relevant technical working groups. Furthermore, the CBM is responsible for notifying relevant European authorities of its macroprudential policy decisions. In areas related to capital buffers for which the responsibility lies with the MFSA, the process of notification to the ECB/ESRB is agreed between the CBM and the MFSA, either jointly or in consultation with the JFSB.

53. The MFSA assigns supervisory responsibilities largely along sectoral lines, with a cross-sectoral approach adopted for authorization, regulatory development, conduct supervision, and enforcement. The supervision and enforcement units of the MFSA are: Banking Supervision Unit, Conduct Supervision Unit (CSU), Insurance and Pensions Supervision Unit (IPSU), Securities and Markets Supervision Unit (SMSU), Regulatory Development Unit (RDU), Authorization Unit, and Enforcement Unit. The respective accountabilities of these units are summarized in Appendix I.

B. Mandates and Legal Powers

54. The MFSA has a broad supervisory mandate. It took over the supervisory functions previously carried out by the CBM, the MSE, and the Malta Financial Services Centre. The current prudential and conduct supervision mandate of the MFSA covers a broad range of entities:

- Banking industry: including credit institutions and financial institutions (FIs) and as resolution authority for credit institutions;

- Insurance industry: including insurers, reinsurers, captive insurers, and insurance intermediaries;

- Capital markets: investment services license holders, CISs, regulated markets (including market surveillance), central securities depositories, financial market infrastructures, recognized private CISs, registered tied agents, recognized administrators, and as the listing authority;

- Other regulated entities: trust management companies, listed entities, Registry of Companies, company services providers, pension schemes, pension funds, and pension service providers; and

[39] Article 17B of CBM Act.

- Related supervisory activities: promoting financial stability, AML/CFT supervision, enforcement, and regulatory development including in the area of FinTech and consumer education.

55. The functions of the MFSA are clearly set out under the law.[40] Its statutory functions are to: (a) regulate, monitor, and supervise financial services[41] in Malta; (b) promote the general interests and legitimate expectations of consumers and fair competition practices; (c) monitor business conduct of FIs and provide relevant information and guidance to the public; (d) enforce financial sector laws; (e) advise the government on financial sector policies; (f) investigate allegations of practices and activities detrimental to consumers and take appropriate deterrent measures; (g) ensure high standards of conduct and management throughout the financial system; and (h) perform such other functions as may be assigned under the MFSA Act or any other law.

56. The MFSA must meet the supervisory objectives established under the respective sectoral laws. Pursuant to the Insurance Business Act, the MFSA is required to have regard for: (a) the protection of insured persons, policyholders, beneficiaries, and the general public; (b) the protection of the reputation of Malta, taking account of Malta's international commitments; and (c) the promotion of competition and choice.[42] While not explicitly stated in the Investment Services Act, the objectives of the MFSA's securities supervision are: (i) safeguarding financial stability; (ii) protecting the investor; and (iii) ensuring that the financial markets are fair, efficient, and transparent. For the avoidance of doubt, the MFSA has proposed amending the MFSA Act to include promoting financial stability and financial market integrity as one of its key functions.

57. The Minister responsible for the regulation of financial services makes regulations to transpose and implement EU directives/regulations based on the advice of the MFSA, while the MFSA is empowered to issue legally binding rules and directives. An administrative penalty of up to €150,000 may be imposed for each infringement of or failure to comply with any provision of the MFSA's rules or directives. Pursuant to various legal notices issued by the minister responsible for the MFSA, the penalties for various breaches of regulations can be increased to €5 million or 10 percent of turnover.[43]

58. The MFSA has adequate legal powers to discharge its supervisory responsibilities. The operational authority of the MFSA includes having reasonable access and entry to business premises; requiring the submission of information and records; examining the affairs of (re)insurers; having the ability to freeze funds and enter and search premises; imposing capital add-on; and

[40] Article 4 of MFSA Act.

[41] Article 2 of MFSA Act: "Financial services'' means the business of credit and financial institutions, the business of insurance and the activities of insurance intermediaries, the provision of investment services and CIS, pensions and retirement funds, regulated markets, central securities depositories and such other areas of activity or services as may be placed under the supervisory and regulatory competence of the Authority by the Minister or by any other law."

[42] Article 4(1) of IB Act.

[43] Since 2017, the MFSA falls under the remit of the office of the Prime Minister. Article 20A of MFSA Act, LN 401 of 2017 (MiFIR and MiFID), LN 222 of 2016 (UCITS), LN 407 of 2017 (CSDR) and LN 32 of 2014 (CRD).

having the ability to suspend or remove any officer of (re)insurers. With respect to investment firms, the MFSA is also empowered to take the necessary supervisory measures to enforce the EU Capital Requirements Regulation and impose specific liquidity requirements.[44]

59. The MFSA also has sufficient legal authority to take necessary preventive and corrective measures in order to protect the public interest. Taking a proportionate approach that reflects the severity of the supervisory concerns or breaches by regulated entities, the MFSA may issue reprimands, warnings, or take other disciplinary sanctions or enforcement measures, all of which must be published on the MFSA's website. Other supervisory measures include requiring regulated entities to rectify or remedy matters (including submission of recovery plan or finance scheme); appointing an advisor, administrator, liquidator, or a person to assume control or take charge of assets of regulated entities; restricting the disposal of the assets; suspending or revoking authorization or registration (insurance intermediary); and ordering the dissolution and winding up of regulated entities.[45]

60. The MFSA is empowered to review and inspect service providers performing any activity or function outsourced by re(insurers).[46] This legal authority is particularly relevant for the MFSA in view of the large number of (re)insurers and investment firms that passport their services to other EU member states. The business models of such regulated entities tend to have a higher level of reliance on outsourcing of key functions such as product distribution or investment. This includes having effective access to the business premises of the service providers, requiring the submission of supervisory information and documentation. Outsourcing by (re)insurers is subject to the prior approval of the IPSU. To ensure the substance of (re)insurers operations in Malta, it is mandatory for (re)insurers to have at least two key functions (internal audit, actuarial, internal control, including compliance, or risk management) and two critical functions (e.g., claims or underwriting) in Malta. Investment intermediaries must have at least two individuals who are residents of Malta. The MFSA may challenge regulated entities for outsourcing a critical or important operational function or activity, where necessary.

61. There are well-established legal gateways for the MFSA to exchange information with relevant supervisors and authorities, both domestically and internationally. Such information exchange is subject to confidentiality, purpose, and use requirements (see Section F on "Supervisory Coordination and Cooperation").

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[44] Articles 29 to 32 of IB Act; Article 16 of MFSA Act; Article 13 to 16A of IS Act; Articles 32 to 34 of Financial Markets Act (FM Act); Schedule III and Reg 18 of ISA(SR)R.

[45] Articles 16, 18, 18C, 26, and 28 of IB Act; Articles 7, 15, and 15A of IS Act; Articles 7, and 8 of FM Act; and Article 15 of Insurance Intermediary Act (IA Act) https://www.mfsa.com.mt/pages/AdministrativeMeasuresPenalties.aspx.

[46] Article 30(7) of IB Act.

Recommendation

- The mission supports the timely finalization of the proposed amendment to the MFSA Act to provide explicit clarity on the MFSA's key functions of promoting financial stability and market integrity.

C. Governance and Transparency

62. The Board of Governors sets the policy and strategic direction of the MFSA. The Board is headed by a Chairperson appointed by the prime minister and comprises seven members including the Chairperson. The Board's oversight of the MFSA is facilitated by the following organs:[47]

- The Supervisory Council, led by the Director General (DG), is responsible for the licensing, regulation, and supervision functions of the MFSA. The Directors of the supervision, authorization, and regulatory development units attend the Council meetings;

- The Board of Management and Resources is in charge of the day-to-day management and the finances. Headed by the Chief Operations Officer, it is responsible for business development, ancillary services, and the general coordination of administrative affairs;

- The Coordination Committee oversees the implementation of policies approved by the Board. It is the principal channel of communication and coordination between the Board of Governors, the Supervisory Council, and the Board of Management and Resources. Members of this committee are the Chairman, the Chief Executive Officer (CEO), the DG, the Chief Operations Officer, and the Director of the Legal Office; and

- The Legal Office provides legal advice and assistance and other services to the MFSA.

63. The Board of Governors also acts as the Listing Authority and the Resolution Authority.[48] The functions of the Listing Authority include, inter alia, authorizing the admissibility of financial instruments, issuing Listing Rules, and ensuring compliance with the Listing Rules. The Listing Authority may establish a Listing Committee, to which it may delegate its functions and powers except for certain specified functions. The SMSU assists and advises the Listing Committee on listing matters. The Resolution Authority has also established a Resolution Committee and a Resolution Unit. The Resolution Authority and the Resolution Committee are mandated to be operationally independent and act independently of each other and of the Supervisory Council.[49]

[47] Article 6 to Article 12 of MFSA Act.

[48] Listing Authority—Article 7A of MFSA Act and FM Act Resolution Authority–Articles 7B and 7C and the first schedule of MFSA Act, Bank Recovery and Resolution Directive, and Recovery and Resolution Regulations.

[49] See also FSAP Technical Note on Banking Supervision and Technical Note on Bank Resolution and Crisis Management.

64. The appointment and dismissal of the Chairperson and Board of Governors are governed by the MFSA Act. They may hold office for up to five years and may be reappointed for another term. The MFSA sets out a list of persons not eligible for appointment. The Prime Minister may dismiss a Governor on the grounds of inability to perform the functions of his/her office, whether due to infirmity of mind or of body, or of misbehavior. While the term "misbehavior" may be broad and subject to interpretation, this is somewhat mitigated by the requirement to publish the reason for termination in the *Gazette*. To date, no Board member has been dismissed for cause.

65. The centralization of decision making at the Supervisory Council helps to promote consistent and proportionate supervisory practices and decisions. All licensing decisions are subject to the Council's approval. All material supervisory issues, including recommendations on potential regulatory action, are reported to the Council for decision. Proposed refusals of appointments of approved persons are also considered by the Council. Supervisory policy issues are discussed at Council meetings before being put forward to the Board of Governors for approval. The Council reviews supervisory priorities and quality assurance matters, as outlined in the MFSA's *Quality Assurance Manual*. During 2017, the Supervisory Council met 55 times.

66. There is established legal procedure for appeals against the MFSA's decisions, including to the Financial Services Tribunal (FST), which is appointed by the Minister. Hearings by the FST are generally open to the public and the decisions of the FST are made public. The competence of the FST is to determine whether the MFSA's decision has wrongly applied the relevant legal provisions or the decision constitutes an abuse of discretion or is manifestly unfair. There is no appeal for any decision carrying a penalty of less than €232.94 or that is from a reprimand, warning, or other similar disciplinary sanction or measure. Appeals against the decision of the FST can be made to the Court of Appeals, but only on a question of law. An appeal to the FST does not suspend the MFSA's directive or decision, except for an appeal against revocation of authorization, in which case the decision will not be operative until the period for making appeal expires. If an appeal is made, the decision becomes operative on the date the FST dismisses the appeal or the date on which the appeal is abandoned.[50] So far, the FST has yet to rule against the MFSA's decisions in response to appeals.

67. The Audit Committee provides independent assurance to the Board of Governors on the governance, controls, and risk-management processes of the MFSA.[51] It determines the role and remit of the IAU and evaluates the performance of the IAU. All three members of the Audit Committee are independent, nonexecutive members of the Board of Governors and are appointed to the Committee in their personal capacity.

68. Set up in November 2016, the IAU adopts a risk-based approach in identifying the audit universe. The IAU's core services are: assurance, advisory, information technology, and investigative. Currently, it has three internal auditors, including the IAU Director, with recruitment in progress to achieve the approved headcount of seven. The IAU is required to have an external

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[50] Article 21 of MFSA Act, Article 58 of IB Act, Article 19(2) of IA Act, and Articles 42 to 44 of FM Act.

[51] Article 12A and Article 12B of MFSA Act.

quality assessment under the standards established by the Institute of Internal Auditors and the ECB, with the next assessment scheduled for 2019. The IAU is also required to undergo internal quality assurance and report back to the ECB. It audited the adequacy and effectiveness of the risk management, controls, and governance processes of the IPSU Compliance Team, with specific reference to onsite work in June 2017 (refer to the audit comments highlighted under Section 4 on Supervisory Capacity). The internal audit of the SMSU supervisory activities is planned for 2019.

69. The MFSA has proposed amendments to the MFSA Act to enhance its governance framework and improve operational efficiency. This follows the recent amendment to the MFSA Act to separate the roles of the Chairperson and the CEO,[52] with a clear segregation of the policy and strategic role of the nonexecutive Chairperson and the Board, while the CEO is accountable for executive functions of the MFSA. The key changes pending legislative approval include:

- A new organization chart aimed at improving accountability and efficiency. An Executive Committee will be established to replace the Supervisory Council and to act as the Listing Authority. The Executive Committee will be led by the CEO and five Chief Officers appointed by the CEO to take charge of: supervision, strategy and innovation, enforcement, legal, and operations. Except for the Chief Officer Operations and Chief Officer Supervision (current DG), the other three positions are new.

- Greater focus on the AML/CFT issues, enterprise risk management, research, FinTech developments, and knowledge management. To this end, two new supervisory committees will be introduced: the AML Committee and a Risk Committee. The functions of risk management[53] as well as program management and quality assurance will report directly to the CEO. The Board of Governors will formally set the MFSA's risk appetite.

- An Academy for Financial Supervisors will be established to spearhead training for the supervisors.

Going forward, technology and knowledge management will be the key enablers of the MFSA's modernization. Hence, a three-year plan is being developed to upgrade the MFSA's information and communication technology infrastructure and to explore the adoption of regulatory technology (RegTech) to improve supervisory efficiency.

70. The MFSA has established an Ethics Framework as part of its governance culture. Under the Ethics Framework, all staff members and members of decision-making and internal bodies of the MFSA are required to ensure the credibility, reputation, and public confidence in the integrity and impartiality of the MFSA. They are required to comply with established ethics standards and relevant provisions in the *Staff Handbook*.

[52] The CEO is appointed by the Board of Governors (Article 2 of MFSA Act).

[53] Currently, risk management is focused at the sectoral supervisory level, and a more holistic approach incorporating operational and reputational risks will be adopted.

71. The *Staff Handbook* sets out clear rules on managing conflicts of interest by staff members and the Board of Governors. They are expected to be vigilant against actual or potential conflicts of interests and declare any potential conflicts of interest immediately in accordance with the Ethics Framework. The declaration of potential conflicts of interest includes any personal interest in regulated entities as well as interests held in these entities by their spouses, civil partners, dependents, and immediate family members. In addition, cooling-off periods (two or six months) apply to managers within any of the regulatory units represented on the Supervisory Council, the Enforcement Unit, and the Resolution Unit on the termination of their employment. This requirement does not apply to support staff, non-clerical staff, staff falling within the Operational Units, and the Legal and International Relations Units.

72. The MFSA consults the public on regulatory changes and provides comprehensive information on its website. Regulated entities and the public have easy access to relevant financial sector legislation and regulations, MFSA Annual Reports, and MFSA Consumer Complaints Reports, consultations, sanctions, penalties, and warnings as well as lists and databases of regulated entities. The MFSA is also required to disclose specific information in line with the Solvency II Directive and the Capital Requirements Directive, aimed at fostering a uniform level of transparency and accountability of supervisory authorities in the EU. Such information is disclosed in a common format and shall be sufficient to enable a comparison of the supervisory approaches adopted by the regulatory authorities of the different EU member states.[54]

Recommendation

- Given the key role played by the IAU in the MFSA's governance framework, the MFSA is encouraged to ensure that the IAU is adequately resourced promptly, including timely recruitment to achieve the approved headcount.

D. Operational and Financial Independence

73. Operational and financial independence is a critical factor for a supervisor's ability to supervise effectively. To be operationally independent, a supervisor and staff must be free from undue political, governmental, and industry interference in the performance of their supervisory responsibilities. An effective supervisor is also financed in a manner that does not undermine independence. More important, the supervisor should have discretion to allocate resources in accordance with the mandate and objectives, and the risks perceived.

74. Within the parameters of the functions and powers granted to it by law, the MFSA has operational autonomy to discharge its responsibilities. In determining the policies to be pursued

[54] Reg 6 of the IBS(GPS)R 2015 and the ISA(SR)R. The specific information disclosures include: laws, regulations, administrative rules, general guidance; aggregate statistical data; the manner of exercise of the options and discretions available in the EU (e.g., Solvency II Directive); supervisory objectives; functions and activities; supervisory review process; and supervisory measures taken, and administrative penalties imposed.

by the MFSA, the Board of Governors is required to follow policy guidelines as may be set out by the government. In this regard, the Board of Governors is also responsible for advising the government generally on the formulation of financial sector policies.[55] There has not been any evidence of government interference in institution-specific supervisory matters. Supervisory decisions are made by the Supervisory Council without the need for external approval. While the Board of Governors is notified of key supervisory decisions, it does not have veto power over the Council.

75. The MFSA's operational independence is balanced by public accountability policies and mechanisms. The MFSA reports to the parliament on an annual basis and must carry on its duties in a transparent and accountable manner. In addition, the MFSA is required to keep proper books of accounts and have its financial statements audited. The audited financial statements together with the annual report are presented to the parliament through the Minister. Also, the MFSA's annual estimates of income and expenditure are to be examined by a committee of the parliament appointed for this purpose.[56]

76. The MFSA publishes its Annual Reports and its audited financial statements on its website. Some of the MFSA's functions are to keep the general public informed of important developments in the financial sector and to provide the public with relevant information and guidance. The MFSA is also obliged to make public all sanctions and penalties it imposes on regulated entities. The notice published on the website is to indicate clearly whether the penalty or sanction is currently being appealed, where this is applicable.[57]

77. The MFSA is funded by fees and charges derived from supervisory functions, other income from its assets, and investments and from the Consolidated Fund. The MFSA currently regulates over 2,180 licensees, an increase of over 360 (about 20 percent) during the past three years.[58] In the past, annual fees were revised every five years with the objective of ensuring that expenses of MFSA were adequately covered and provisions for contingencies could be made. Insurers' annual fees are computed based on their GWP, while the annual license fees for investment firms/securities firms are based on their revenue from investment services activity. The MFSA is required to establish a reserve fund to which the surplus for the financial year shall be appropriated.[59] The reserve fund must not, at any time, exceed the operational expenses recorded in

[55] Article 4(1)(e) and Article 6 of MFSA Act.

[56] Articles 23, 27, and 28 of MFSA Act and Reg 6 of Insurance Business (General Provisions of Supervision) Regulations (IB(GPS)R).

[57] Articles 4(1)c), 16(8) of MFSA Act.

[58] *MFSA Newsletter May 2018*.

[59] The reserve fund was €15.1 million as of end-2017, equivalent to the operating expenses of 2016. The pegging to operating expenses implies that the reserve fund could be used to meet unexpected expenses. There is no legal provision governing the use of the reserve fund, and no precedent, as the MFSA thus far has not encountered a funding shortfall.

the preceding financial year. Any surplus after the allocation to the fund must be paid to the Government.[60]

78. While the MFSA's funding has been sufficient and stable, an increasing trend of funding shortfall is forecasted, largely due to a separation of the ROC functions and the implementation of the MFSA's strategic plan. The MFSA Act was amended recently to stipulate that any shortfall in the MFSA's funding shall be paid out of the Consolidated Fund.[61] The MFSA's financial projection for 2019–21 indicates an increasing trend of funding shortfall. This is largely attributable to:

- The loss of the ROC's revenue, a key source of funding for the MFSA. The ROC's functions, previously operated from the MFSA, was migrated to a new Registry of Companies Agency as of April 2018; and

- Higher operating expenses, particularly payroll costs. The MFSA urgently needs to address the severe gap in supervisory capacity by hiring more qualified supervisors, which has to be supported by a more calibrated staff compensation framework (see Section 4 on supervisory resources). In addition, the proposed upgrading of the MFSA's infrastructure requires commitment in capital expenditure (see paragraph 69).

79. It is important that the MFSA has stable funding to sustain its financial independence and to meet its supervisory objectives.[62] The recent change in the MFSA´s funding model introduces a degree of uncertainty by requiring the MFSA to negotiate for governmental and parliamentary approval of its budget on a yearly basis. A year-to-year subvention from the Government would not provide the MFSA with stability in funding, with significant implications for the MFSA's financial autonomy, including its ability to implement planned supervisory activities and meet its capital expenditure commitment. To ensure stable funding, the MFSA should develop a five-year plan to increase its budgetary resources in a sustained way, and the plan should be supported by a strong public commitment from the Government. On the revenue side, the MFSA would need to review its policy for license fees and the basis used for other regulatory charges. The MFSA would need to conduct research and a feasibility study on the appropriate basis for license fees and regulatory charges and consult the industry accordingly. However, it is preferable that the fee revision be implemented in a gradual and phased manner over the next three to five years to avoid a sudden and drastic increase in regulatory burden to the industry. Hence, Government subventions would be required during the transition period.

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[60] Articles 22 and 26 of MFSA Act, Insurance Business Fees Regulations (LN 139/1999) last amended in 2009.

[61] Article 22 of MFSA Act. The same provision applies to the salaries/allowances payable to the holders of key offices such as the judiciary, the Attorney General, and the Public Service Commission.

[62] The explanatory note for IOSCO Principle 2 states: "A stable source of funding is critical because operational independence can be compromised if funding can be curtailed by external action."

80. The MFSA must comply with recruitment policy and procedures applicable to public sector entities, which constrain its recruitment efforts. Besides the tight labor market conditions in Malta, the MFSA has to abide by public sector recruitment policies and procedures. Since 2005, the MFSA has been required to obtain endorsement by the MFIN of the projected budget to be allocated for human resources on a yearly basis; and of the Office of the Parliamentary Secretary for Financial Services, Digital Economy and Innovation, to approve all the vacancies in accordance with an HR plan in terms of the applicable public-sector policies and procedures. Notably, the CBM and the MSE have been exempted from this procedure.[63]

81. Some industry players have suggested that one of the key challenges faced by the MFSA in recruitment is the perception that a career with the MFSA is less attractive because the MFSA staff members are public-sector employees. The continued application of the above public sector's recruitment policy to the MFSA may entrench this external perception. More important, there is pressing need for the MFSA to attract qualified and experienced staff, particularly given the intense competition from the financial industries. It is timely that the MFSA be exempted from public-sector recruitment policies and procedures.

Recommendations

To maintain the financial and operational independence of the MFSA, the authorities should consider:

- putting in place appropriate measures to ensure stability of funding for the MFSA; and
- exempting the MFSA from the recruitment policies and procedures applicable to public sector entities.[64]

E. Confidentiality Safeguards and Legal Protection

82. The Board of Directors and any organs of the MFSA, its officers, and employees must safeguard the confidentiality of any information acquired in the discharge of their duties. This legal obligation also applies to the former officers and employees of the MFSA, as well as to inspectors, auditors, and experts acting on behalf of the MFSA. They must not, directly or indirectly, disclose such information to any other person, except with the consent of the person who had divulged the information. Nonetheless, disclosure can be done in summary or aggregate form such

[63] Manual for public sector entities: delegation of authority to effect recruitment, promotions and industrial relations, section 3.1.1.

[64] Following discussions with the FSAP mission team, the cabinet decided in October 2018 to add the MFSA to the list of entities that are exempt from the recruitment policies and procedures applicable to public-sector entities (Directive 7). As the amendment took place after the end of the FSAP mission, it was not reviewed by the team.

that not to enable the identity of the entity, to whom such information relates, to be ascertained.[65] It may also be done for certain reasons as discussed below.

83. The MFSA has implemented policy and procedures to help ensure that staff members observe strict confidentiality. The duty to protect professional secrecy is reiterated in the *MFSA Staff Handbook,* which states that a breach of confidentiality can lead to a dismissal of an employee without notice. The letters of appointment of employees also refer to the duty of confidentiality of employees.[66] The MFSA has adopted the Common Rules Minimum Standards policy that provides for the classification of the documents, according to the degree of sensitivity and issued guidelines of the policy.

84. There are established legal gateways for the MFSA to exchange information with relevant authorities in Malta, the EU, and third countries. Such exchange is subject to confidentiality, purpose, and use requirements. The specified authorities include financial regulators, enforcement agencies, ESAs, ESRB, the European Commission, statutory auditors and their regulators, liquidators, administrator, investigators, and actuaries. [67]

85. The MFSA, members of its Board of Governors, and its officers and employees have legal protection in the exercise of their official duties, except for acts/omissions done in bad faith. The MFSA has committed to supporting staff members in the event of legal actions initiated against them. This would include financial support to cover costs or losses sustained, including obtaining legal advice or the necessary financial guarantees for the revocation of precautionary warrant.[68]

F. Supervisory Coordination and Cooperation

86. The MFSA has signed an MoU with the CBM to facilitate the exchange of information pertaining to financial services as well as payment and securities settlement systems. The MoU also established a Standing Committee as a forum to foster the effective exchange of views. Both parties have appointed contact persons and set relevant processes, including for information sharing in line with the MFSA Act and the Central Bank Act.

87. The CBM, the MFSA, and the MFIN have jointly set up a Crisis Management Committee and executed an MoU to coordinate in the prevention and management of financial crisis. The authorities are also signatories to the EU 2008 MoU on cooperation among the financial supervisory authorities, central banks, and finance ministries of the EU on cross-border financial stability. Under these MOUs, the signatories undertake to exchange information and cooperate on a domestic and cross-border level in crisis management and resolution in order to ensure long-term financial stability and to reduce the potential public cost of possible future financial crises. This entails having

[65] Article 17 of MFSA Act, Article 59 of IB Act, Article 26 of IS Act, s38 of FMA.

[66] s2.6 and s3.20 of *MFSA Staff Handbook*.

[67] Article 17 of MFSA Act, Article 55 of IB Act, Reg 6(6) and Schedule V of ISA(SR)R.

[68] s29 of MFSA Act, Article 66 of IB Act, and s3.24 of *MFSA Staff Handbook*.

in place the appropriate infrastructure to effectively support this cooperation, which also extends to the participation in simulation exercises within the EU and domestically.

88. The MFSA and the FIAU have signed an MoU relating to cooperation in AML/CFT supervision in 2014. The MFSA also established a dedicated AML/CFT team within the Enforcement Unit in 2015 to assist the FIAU in carrying out AML/CFT inspections of regulated entities. As from 2017, both agencies adopted a joint AML/CFT supervisory mechanism and common joint examination procedures. These recent developments in supervisory cooperation are reflected in the AML/CFT MoU, which was signed in August 2018.[69]

89. The MFSA has also signed a number of bilateral MoUs with international regulators of financial services. It is also a signatory to specialized multilateral MoUs through organizations such as IOSCO, EIOPA, and ESMA. The MFSA is a signatory to five coordination arrangements entered with the other European regulatory authorities for the establishment of supervisory colleges. A list of the MoUs executed is published on the MFSA's website.[70]

SUPERVISORY FRAMEWORK AND RESOURCES

A. Background Context

90. The ability to build and maintain strong technical capacity is another prerequisite for an effective supervisor. The standing of the supervisor, including operational and financial independence, is critical for attracting and retaining skilled staff to exercise proactive and holistic supervision. Inadequate resources would result in a supervisor having to make difficult compromises in performing its functions, posing unintended risks to the policyholders, beneficiaries, investors, and the financial system as a whole.

91. In the aftermath of the global financial crisis in 2008/2009, international standard setters have raised the benchmarks on supervisory practices and effectiveness through enhanced core principles. Concurrently, the Supervisory Intensity and Effectiveness Group of the Financial Stability Board has provided guidance to promote robust supervisory practices. The current supervisory paradigm calls for skilled and experienced supervisors who are able to have credible interactions with regulated entities on strategic issues, such as risk aptitude/culture, and to exercise sound and forward-looking judgment. In line with international best practices, the MFSA is expected to have the appropriate supervisory intensity and effectiveness commensurate with the state of financial market development in Malta.

92. The IB Act has established a legal framework for the MFSA's supervisory review process for insurance firms.[71] The MFSA is to review and evaluate the strategies, processes, and reporting procedures established by re(insurers). Supervisory assessment should ascertain

[69] MFSA and FIAU cooperation is discussed in the Technical Notes on AML/CFT and on Banking Supervision.

[70] https://www.mfsa.com.mt/pages/viewcontent.aspx?id=22.

[71] Article 31B of IB Act.

compliance with regulatory requirement, including those relating to governance, risk management, technical provisions, capital requirements, investments, own funds, use of internal models, and stress testing. Supervisory reviews shall be conducted regularly and the MFSA shall establish the minimum frequency and the scope of the reviews, having regard for the nature, scale, and complexity of the activities of the (re)insurers concerned.

93. **The Investment Service Act (Supervisory Review) Regulations (ISA(SR)R) outlines minimum supervisory review and evaluation for the securities sector.** In addition to credit, market, and operational risks, the SMSU is expected to perform supervisory assessments that cover, inter alia, investment firms' stress testing framework, concentration risks, use of recognized credit risk mitigation techniques, adequacy of own funds, liquidity risks, business model, geographical location of exposures, excessive leverage, and systemic risks. The SMSU must formulate annual supervisory examination programs and undertake more intensive and frequent supervisory activities (including permanent presence at the firm) where appropriate.[72]

94. **Since 2018, each supervisory unit within the MFSA is to identify and submit the list of the top five risky entities under its remit to the Supervisory Council.** The submissions include an update of the supervisory approach adopted for these entities. Any onsite review reports of such entities should also be reviewed by the Supervisory Council before finalization.

B. Risk-Based Supervision and Macroprudential Surveillance

Insurance and Pension Supervision Unit (IPSU)

95. **The MFSA is required to adopt a prospective and risk-based approach to supervision.** This entails timely and proportionate supervision through an appropriate combination of offsite and onsite supervisory activities. The MFSA shall apply regulatory requirements that are commensurate with the nature, scale, and complexity of the risks inherent in the business of (re)insurers concerned, taking into consideration their risk profiles and systemic impact.[73]

96. **The Supervisory Review Process (SRP) of the IPSU encompasses supervisory activities to fulfill the MFSA's obligations under the Solvency II Directive.** They include the evaluation of strategies, processes, and reporting procedures established by (re)insurers to comply with insurance legislation. In particular, the IPSU reviews and evaluates (re)insurers' own-risk and solvency assessment (ORSA), technical provisions, capital requirements, quality and quantity of own funds, as well as ensures that their investments are made in accordance with the prudent person principle. The SRP is documented and published on the MFSA's website.[74]

97. **As part of the SRP, (re)insurers are assessed on a periodic basis based on a risk assessment cycle.** This is the process through which IPSU supervisors gain an understanding of the risks that (re)insurers face or may be exposed to and the specific controls that are in place. The risk

[72] Schedule 1 and 2 of ISA(SR)R.

[73] Reg4(3) of IB(GPS)R.

[74] Article 31B of IB Act and Article 36 of Solvency II Directive.

assessment cycle comprises a number of steps: risk identification, risk evaluation, analysis of undertaking's management actions and controls, risk scoring, supervisory activities, and monitoring of risks and mitigation actions.

98. The IPSU has formulated a Risk Assessment Framework (RAF) to assess risks of (re)insurers based on the level of risk impact and the probability of risk (i.e., the likelihood of occurrence). It incorporates five stages: assessment of information; determination of impact classification; determination of probability classification; determination of risk score; and determination of intensity, and frequency of supervision.

99. Impact assessment is done on an annual basis through a combination of metrics, quantitative indicators, and supervisory judgment. Risk impact is classified into four categories: Low, Medium Low, Medium High, and High. This assessment reflects the potential impact that the failure of a particular (re)insurer/insurance group on its policyholders and financial system. Quantitative indicators are also adjusted to reflect different types of insurance business (i.e., non-life, life, composite, captives, etc.) and concentration in business lines. The impact classification of an insurance group considers the complexity and interconnectedness of the insurance group.

100. The probability evaluation, also conducted annually, takes into account both current and future risks, including the ability of a (re)insurer/insurance group to withstand possible events or future changes in economic conditions. The IPSU classifies probability into four categories—Low, Medium Low, Medium High, and High. The probability classification process involves assessments of risks, controls, risk drivers, and relevant risks to the insurance sector. For insurance groups, the IPSU also considers other group-specific issues. Both quantitative and qualitative information is considered to arrive at a net probability score for each (re)insurer, which may be adjusted by supervisory judgment.

101. There is room for enhancing the Impact and Probability Risk Oversight System (IMROVE), a supervisory tool developed by the IPSU. IMROVE identifies three main risk drivers: the quality of governance, macroeconomic risks, and business model. The analysis of these risk drivers complements the ORSA report submitted by (re)insurers in identifying future risks and the possible adverse effects. The IPSU acknowledges that the monitoring of macro-risks and business model analysis (e.g., cross-border activities and geographical risk concentration) could be enhanced. The IPSU also intends to develop its own stress testing framework to complement the tests conducted by (re)insurers.

102. The IPSU assigns an overall risk score for each (re)insurer based on the impact and probability assessment. The impact and probability classifications of all (re)insurers are compared on a risk map to understand which ones pose the highest combined risk. The overall risk classifications are:

- High Risk: possibly at risk of detriment due to the risks they face and not meeting their obligations to policyholders and beneficiaries in the short and long terms. (Re)insurers may also be in this category, due mainly to their size and higher potential impact in the market;

- Medium High Risk: at risk of suffering detriment due to the higher likelihood that their identified risks will materialize;
- Medium Low: not expected to suffer detriment or impact policyholders or the market significantly if their identified risks materialize; and
- Low Risk: low likelihood of risks materializing.

103. The IPSU's supervisory plan is driven by the RAF. The overall risk scores, in conjunction with other supervisory information, are used to set the supervisory plan for each (re)insurer. The plan outlines the supervisory work to be carried out by each team within the IPSU, including the frequency and intensity of supervisory activities. In turn, the supervisory plan is supported by a number of documented procedures detailing how supervisory activities are to be carried out and by whom. The IPSU has also integrated and adopted a number of recommendations and good practices that are noted in the *EIOPA Supervisory Handbook*.

104. The IPSU has established a high-level policy on the form and level of judgment to be undertaken at each stage of the SRP. This is in recognition of supervisory judgment being critical for a forward-looking supervisory approach. The use of judgment may sometimes result in overriding the quantitative assessment under the RAF. Hence, this policy is intended to ensure appropriate use of supervisory judgment while allowing flexibility within specific parameters. It will also help ensure that a consistent approach is maintained at all stages of the SRP. For example, the IPSU is drafting a *System of Governance Manual* to ensure consistency in supervisory judgment on what constitutes good governance practices, taking into consideration the proportionality principle.

105. Going forward, the IPSU will be conducting impact and probability assessments on a quarterly basis based on a limited set of metrics and indicators. This will help enhance monitoring in a timely manner and enable a more proactive supervisory stance and early intervention.

Securities Market Supervision Unit (SMSU)

106. The SMSU is working toward completing a risk monitoring system (RMS) as part of its risk-based supervision. The stated objectives are to provide a more efficient method for the management and optimization of scarce supervisory resources, adopt a more proactive style of supervision, and allow early intervention to reduce the impact and probability of emerging risks. The risk assessments are conducted annually according to the *Risk Monitoring Manual* established by the SMSU. Under the RMS, licensees are ranked in accordance with their Total Composite Risk rating (TCR), which determines the intensity and focus of SMSU's supervision of their operations.

107. Different risk quantitative criteria (RQC) have been tailored for different categories of licensees to assess their risk profiles. The RMS assesses risks posed by each licensee in isolation. It is not intended to capture interlinkages between different licensees and with other parts of the financial sector, nor systemic impact. Risk ratings are assigned to RQC, which are weighted equally but could be adjusted by the analysts. The RQC include both probability and impact variables, which are rated and mapped on the probability and impact matrix.[75] A separate summation of all the variables for probability and impact is carried out to derive the total probability rating (TPR) and the total impact rating (TIR) for each licensee.[76] The TCR is then computed by multiplying the TPR by the TIR, ranging between 1.6 percent and 100 percent. The higher the TCR, the higher the risk posed by the licensee to investors and the SMSU's supervisory objectives. The RMS will then categorize licensees into low-, medium-, or high-risk categories based on their TCR.

108. The RMS drives the annual supervisory plan that sets out the supervisory activities of each team within the SMSU. The plan will reflect the frequency and intensity of supervision for each licensee as determined by its TCR. The supervisory plan is supported by a number of documented procedures on how supervisory activities are to be carried out and by whom. The SMSU observes the principle of proportionality throughout all stages of the supervisory review process and seeks to ensure a consistent supervisory review process for all categories of licensees.

Conduct Supervision

109. The CSU took over the conduct supervision of investment firms effective September 1, 2016. The key areas of the CSU's supervision include: client disclosure and reporting; financial product governance; management of conflict of interests; selling processes and practices; contractual agreements with retail clients; execution of clients' orders; and governance of regulated persons. The Board of Governors mandated the CSU to issue the *Conduct of Business Rulebook*, which was published in December 2017 following a three-year period of consultation with industry participants and relevant stakeholders. Conduct supervision of the insurance sector is currently being covered by the IPSU, pending resourcing of the conduct supervision team within the CSU, expected to be completed by end-2018.

110. It would appear there is no clear supervisory stance and baseline supervision program with respect to conduct supervision, particularly for banks acting as distributors of insurance and securities product. Based on market feedback, the MFSA has not performed onsite conduct supervision of one major bank in its capacity as a tied insurance intermediary for related insurers and asset managers within the same group. As part of an onsite review of an insurance principal, the MFSA interviewed a number of staff members of a related bank involved in the distribution of insurance products to gauge their understanding of rules applicable to insurance intermediaries. However, this fell short of a proper inspection of the business conduct of the intermediaries and related governance and controls.

Ongoing Initiatives

111. As part of the MFSA's efforts to enhance supervisory effectiveness and efficiency, the MFSA is formulating an integrated risk-based supervision framework (RBSF). This framework

[75] The ratings are 5=low, 22.5=medium, 40=high, based on predetermined thresholds (e.g., levels of total assets as an impact RQC and number of customers) and qualitative considerations (e.g., governance and nature of breaches or number/nature of complaints).

[76] The TPR ranges between 50 and 400, while the TIR ranges between 20 and 160.

will allow the MFSA to apply a harmonized risk-based approach to supervising regulated entities in the banking, insurance, and securities sectors, taking inputs from the ECB risk-based supervision process. This integrated approach will also foster common understanding among different supervisory units and consistency in supervision across the financial sector. The MFSA is also taking advantage of this business process re-engineering to enhance the effectiveness of the existing RBSF that is currently employed by the IPSU and the SMSU, including embedding the assessment of business risk elements[77] in the RBSF.

Recommendations

- It is advisable for the MFSA to formulate a clear supervisory stance, including a baseline supervisory program for conduct supervision, particularly for banks acting as distributors of insurance and securities products.

- The ongoing initiative to improve and harmonize the MFSA's risk-based supervision framework is commendable. It is important that the MFSA maintains the momentum and finalizes the framework in a timely manner.

Macroprudential Surveillance[78]

112. The MFSA contributes to the financial stability oversight of Malta through its participation at the JFSB. Recommendations on macroprudential policy by the JFSB are forwarded to the Board of Directors of the CBM to be considered for adoption, as the CBM is the designated authority for macroprudential policy implementation.[79]

113. The MFSA shall have regard for the potential impact of its decisions on the stability of the financial system in the EU in the exercise of its duties.[80] The MFSA is also required to take account of an EU dimension in discharging its supervisory responsibilities. The ESRB is responsible for EU-wide macroprudential oversight and issues opinions, warnings, and/or recommendations on financial stability risks to the EU as a whole or to relevant member states. There is an established process for coordinating cross-border reciprocity of macroprudential policies through notifications and nonobjection of the use of certain macroprudential tools. The EIOPA conducts regular EU-wide stress tests and ensures coordinated crisis prevention and management among the NCAs.

114. Within the MFSA, the RDU has a financial stability and macroprudential focus. The RDU is charged with independent analysis of the financial services sector and complements the work done by the CBM, which is the designated macroprudential authority in Malta. In order to identify,

[77] These include environment risks; customers, products and markets; business process risks; and prudential risks.

[78] Macroprudential surveillance is defined as a set of systems and processes that monitors the vulnerability of the financial system with respect to economic and financial shocks. One of the aims of macroprudential surveillance and regulation is to: identify systemic risk (including shocks, interconnectedness, and feedback effects); reduce the likelihood of systemic risk; and mitigate spillover effects within the financial system and into the real economy.

[79] Article 17B of Central Bank Act.

[80] Reg 3 of IB(GPS)R and Reg 5 of ISA(SR)R.

monitor, and analyze developments and factors that might impact financial stability, the RDU performs a macroprudential risk assessment twice a year. As part of the assessment, the RDU conducts bilateral discussions with the respective supervisory units at a technical level. The RDU's financial stability assessments are then formally presented to the Supervisory Council.

115. The RDU is building macroprudential surveillance capabilities for the insurance and securities sectors and targeting financial stability and systemic risk in the Maltese financial system in line with its current mandate. With one full-time equivalent (FTE) staff and two FTE staff monitoring the insurance and securities sectors, respectively, the current scale of the RDU's surveillance is limited to the eight domestic insurers and the DIFs, in terms of surveyed entities prone to propagation of systemic risk to the Maltese financial system. The RDU also has yet to formulate supporting models for its domestic systemic risk and financial stability analysis of the insurance and securities sector, except for the investment funds liquidity stress testing.

Recommendation

- Going forward, it is important that the RDU cultivates the necessary expertise to enable more holistic macroprudential surveillance, with tailored methodology and models that reflect the risks profiles of the insurance and securities sectors.

C. Supervisory Capacity

116. The number of supervisory staff in the IPSU and the SMSU has increased marginally since 2013 (Table 7). In 2017, the IPSU had 23.5 FTE staff, while the SMSU had 39 FTE staff, with extensive scope of supervision:

- As at end-March 2018, the IPSU was responsible for the supervision of 65 (re)insurers, one reinsurance SPV, 11 insurance managers, 16 insurance agents, 32 insurance brokers, 459 tied insurance intermediaries, 16 retirement scheme administrators, 51 retirement schemes, two retirement funds, 12 investment managers, and eight back-office administrators; and

- The SMSU's supervisory mandate covers: 162 investment intermediaries, 688 investment funds, 26 fund administrators, regulated market infrastructures, enforcement of listing requirements, processing of notifications pursuant to the Securitization Act (since March 2018), and market surveillance. The SMSU is also responsible for developing a regulatory framework for initial coin offerings, virtual financial assets, and related service providers.

117. Supervision of insurance groups is conducted by IPSU supervisors responsible for the supervision of the solo insurers' forming part of the group. The MFSA has identified 27 insurance groups. The MFSA is the designated group supervisor for the Darag Group and Compre

Group and has set up a college of supervisors for these two groups.[81] The MFSA is also a member of the supervisory colleges of four international insurance groups.[82] Supervisory colleges where the MFSA is a member are coordinated and attended by the Deputy Director of Finance, assisted by the supervisory staff allocated to the specific insurance group, where necessary.

118. As the group supervisor, the IPSU's functions include:

- coordination of the gathering and dissemination of relevant or essential information for going concerns and emergency situations;
- supervisory review and assessment of the financial situation of the group;
- assessment of compliance of the group with the rules on solvency, risk concentration, and intragroup transactions;
- assessment of the system of governance of the group, including the fitness and propriety of the Board of Directors of the participating undertakings; and
- planning and coordination through regular meetings, or other appropriate means, of supervisory activities in going concerns as well as in emergency situations in cooperation with the relevant authorities.

[81] A college of supervisors is not required for the remaining 25 insurance groups, as they are Maltese groups, with the MFSA as the only involved regulator.

[82] They are the Munich Re Group, Germany; the Mapfre Group, Spain; the Bupa Group, UK; and the Wesleyan Group, UK.

Table 7. Analysis of Supervisory Resources

	2013	2015	2017	
FTE	**IPSU**	**SMSU**	**IPSU**	**SMSU**[2/]
Offsite review	22.5	21.0	23.5	28.0
Onsite inspection[1/]		4.0		10.5
Macroprudential surveillance	0.5	0.5	1.0	1.5
Others	Nil	1.0	Nil	1.0
Subtotal	22.5	26.0	23.5	39.5
Supervisory Experience				
Fewer than 3 years	14.0	14.0	11.5	23.0
More than 3 but fewer than 5 years	Nil	5.0	3.0	5.5
More than 5 but fewer than 10 years	1.0	4.5	6.0	8.5
More than 10 years	7.5	2.5	3.0	2.5
Subtotal	22.5	26.0	23.5	39.5

Source: MFSA.

[1/] The IPSU offsite supervisors also cover onsite inspections. For SMSU, 7 of the offsite supervisors had dual roles covering both offsite review and onsite inspection in 2015 and 2017.

[2/] The Investment Services License Holder team within the CSU was created in September 2016.

119. Similarly, the resources allocated to financial conglomerates are the supervisors of the different regulated entities within the conglomerates. There are two Maltese financial conglomerates. Neither of them requires the establishment of a supervisory college, because the MFSA is the only relevant competent authority. The conglomerates are supervised by a Joint Supervisory Team comprising staff from the ECB and the MFSA.

120. Over the past three years, the MFSA has delivered an intensive program of legislative and regulatory developments. They include the transposition and implementation of EU legislation and updates to various regulatory frameworks domestically. These developments have been driven by significant regulatory overhaul undertaken in the EU, such as the Solvency II Directive,[83] European Commission's Green Paper on Building a Capital Markets Union, Packaged Retail and Insurance-based Investment Products Regulation,[84] UCITS V, MiFID II, and Securitization

[83] Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance.

[84] Regulation (EU) No. 1286/2014 of the European Parliament and of the Council of November 26, 2014, on key information documents for packaged retail and insurance-based investment products. These products can be broadly classified into four groups: investment funds, insurance-based investment products, retail structured securities, and structured term deposits.

Regulation.[85] The new legal acts, notices, rules, and circulars issued by the MFSA each year are listed in Appendixes I to III of the MFSA's Annual Reports for 2015 to 2017. Extensive resources were also applied in conducting the public consultations on these regulatory changes and to compile and assess the feedback received from FIs and the public, as summarized in Appendix IV of the Annual Reports.

121. The MFSA provided technical support to Malta's Presidency of the Council of the European Union during the first half of 2017. As the President, Malta was tasked with leading discussions between EU governments on a number of policy work streams as well as negotiating draft laws with the European Parliament. The presidency came at an important juncture for the financial services sector, particularly in view of technical discussions, including key legislative proposals related to the Capital Markets Union. The Maltese Presidency took on a number of challenging dossiers in these areas, including those related to securitization, venture capital funds and central counterparties, and the new Prospectus Regulation.[86] Representatives from the MFSA participated in all the technical meetings and assisted in the relevant trialogue meetings.

122. Arising from a visit to the IPSU in May 2016, the EIOPA Supervisory Oversight Team has made a number of recommendations to enhance the MFSA's risk-based supervision. One of the key recommendations was for the MFSA to "continue to increase its insurance supervisory staff, to continue to develop mechanisms to attract and retain highly skilled and experienced people in order to be able to respond to the fast-changing business environment and upgrade its supervision toward the more risk-based Solvency II."

123. An independent peer review conducted by ESMA has highlighted the limited resources allocated by the MFSA to the enforcement of financial information examination.[87] During the first quarter of 2017, the ESMA conducted an onsite visit to evaluate the Listing Authority as part of the peer review on *Guidelines on Enforcement of Financial Information*. The report noted that the MFSA allocated "very few resources" for examination of financial information examination "and these resources include the MFSA outsourcing an important part of the job of reviewing financial statements to a third party." This has resulted "in a disclosure checklist approach to the reviews of financial statements without any scrutiny of the recognition and measurement issues *which is* necessary for an effective enforcement. Also, as a result, the MFSA is not building up any expertise or experience, nor is the MFSA holding itself out as an enforcer that challenges issuers, and as an

[85] Regulation (EU) 2017/2402 of the European Parliament and of the Council laying down a general framework for securitization and creating a specific framework for simple, transparent, and standardized securitization, and amending Directives 2009/65/EC, 2009/138/EC, and 2011/61/EU and Regulations (EC) No. 1060/2009 and (EU) No. 648/2012.

[86] Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC, OJ L 168, 30.6.2017.

[87] ESMA—*Guidelines on Enforcement of Financial Information*—Peer Review Report (ESMA 42-111-4138) dated July 18, 2017.

enforcer is somewhat invisible to the market." Arising from ESMA's Peer Review, the Listing Authority informed all listed entities of enhancements to the examination approach and processes on September 12, 2017.

124. The IAU's audit of the IPSU in June 2017 also opined that the IPSU Compliance and Risk team are "ineffective"[88] due to inadequate resources. This rating is the lowest of the IAU's four-stage scale. The audit found that the supervisory processes within the IPSU Compliance Team, which are considered to be important for effective supervision (e.g., regular onsite visits of high-risk licensees and timely issuance of post-visit compliance reports), had been undermined by inadequate resources. The IPSU has informed that, notwithstanding that the resource situation has generally remained unchanged, a number of weaknesses highlighted by the internal auditor are being addressed during the current year.

125. In 2017, about half of the IPSU supervisors had fewer than three years of experience, while the ratio is higher at 60 percent for the SMSU. Notably, the IPSU suffered a high 30 percent and 14 percent turnover rate of supervisors with fewer than three and 10 years of experience, respectively. This was largely attributable to better remuneration in the private sector, exacerbated by industry poaching of supervisors with good Solvency II knowledge and experience. Turnover rates at the SMSU and the CSU have been low, with the departure of only two supervisors in 2017.

126. The MFSA has a comprehensive training roadmap covering: induction, technical, soft skills, and qualifications attained through self-development. The induction program adopts a three-stage approach: i.e., (a) pre-employment and contact on the first day of work; (b) induction training on key internal procedures such as security (physical, access, data) and ethics; and (c) induction training on organizational structures. Technical training gaps are identified, both top-down and bottom-up, which could be delivered either in-house or externally. A similar approach is used for identifying and delivering training needs in soft skills. The Self/Employee Development Scheme offers financial support to MFSA staff undertaking studies leading to a certificate, diploma, first degree, or a master's/post-graduate degree. It is considered the MFSA's strongest confirmation of its commitment to building a qualified workforce.

127. The MFSA also has a structured Career Progress Plan, which will be complemented by a Mentoring Program. The career plan is a written list of short- and long-term goals for employees for attaining their aspirations, which should be linked to their strengths and potential. Assisting employees to achieve their goals is one way to improve staff retention. The MFSA plans to introduce a Mentoring Program, which aims to build a professional relationship between an experienced staff

[88] This opinion reflects the Euro system—Internal Auditors Committee methodology, which describes the rating when the "applicable system of internal controls and governance framework are designed and/or operated such that one or more business objectives may be compromised in a material manner."

member (the mentor) who assists in developing specific skills and knowledge of a mentee to enhance professional and personal growth.

128. The MFSA may hire or contract the services of outside experts when necessary. It is empowered to appoint inspectors, auditors, or experts pursuant to the relevant legislation.[89] These experts are bound by the legal obligation to safeguard confidentiality of information obtained in the course of their work with the MFSA. They are required to sign a confidentiality undertaking; take necessary measures to implement appropriate technical and organizational measures to comply with the data protection law, and to properly manage potential conflicts of interest.

129. Documented supervisory procedures have helped to improve efficiency, somewhat mitigating the stretched resources. The procedure manuals used by the IPSU and the SMSU, for both offsite surveillance and onsite inspections, are structured and sufficiently detailed to guide supervisors in conducting systematic reviews or inspections while promoting consistency in supervisory practices. Nonetheless, there is scope for integrating the common procedures across supervisory units, which may reduce duplicative efforts in updating the manuals and further harmonize supervisory practices. This may also promote a common supervisory culture/language and facilitate flexibility in staff rotation within the MFSA.

130. In 2017, the MFSA commissioned a Human Resource Audit, with the aim of developing a Human Resource strategy. The audit engaged employees at all grades through interviews, surveys, and focus groups. The core findings were divided into three key areas: recruitment, retention, and remuneration. The MFSA has since initiated a number of measures to address the key audit findings and implement the recommendations.

Assessment of Supervisory Capacity

131. The current resources of the MFSA for insurance and securities supervision have lagged behind market and regulatory developments. Malta has sophisticated financial markets and is in the forefront of embracing financial innovation, such as PCC, Incorporated Cell Companies (ICCs), and Fintech. Concurrently, the regulatory regime for the insurance and securities sectors in Malta has been significantly enhanced in accordance with EU regulatory developments. The effective implementation of Solvency II calls for supervisors with the necessary expertise and sound judgment to: conduct business model analysis; assess/approve (re)insurers' internal models and ORSA; and develop local stress testing frameworks, etc. While supervisory resources have remained stable in absolute numbers, significant staff turnover has eroded the level of supervisory experience in the IPSU. Stretched supervisory resources are likely to aggravate staff challenges, as existing staff have to take on additional workloads exacerbated by inadequate guidance for new staff by a declining pool of experienced seniors.

[89] For example, Articles 30(1) and 59 of IB Act, Article 14 of IS Act, and Article 33 of FMA.

132. There is industry consensus that the supervisory effectiveness of the MFSA may be undermined by inadequate resources. Based on interviews with selected industry participants, the severe resource shortage is well known in the industry. Some institutions cited examples where supervisory reports or reviews were only issued after a long delay and processing of certain applications also took a long time. A number of entities commented that the MFSA has not inspected third-party service providers that are performing outsourced key functions outside of Malta.[90] Others voiced concerns that the limited talent pool has resulted in mutual poaching of staff between the MFSA and the financial industry.

133. The MFSA estimated that a significant increase in the staff complement would be required over the next three years to cater for growth in the financial services sector and to regulate emerging sectors, e.g., FinTech and virtual financial assets. This also means an increase of FTEs over the current staff strength. Current initiative of the HR Unit includes engaging private recruitment agencies specializing in Finance/ICT in a drive to attract potentially eligible local and foreign candidates.

134. The lack of adequate local talent is a structural challenge that is not unique to the MFSA. The annual staff turnover rate of 10.5 percent at the MFSA is comparable to the general financial market. Over the past years, the insurance and securities sector in Malta have seen a significant increase in demand for human resources, which has not been matched by growth in the local talent pool. The Maltese population is aging, and only a quarter of new jobs created annually are being filled by locals. The Chairperson of Jobsplus (the local public service employment agency) reported that if the current growth rate in the economy of 6–7 percent on an annual basis is maintained, there will be considerable difficulty in meeting Malta's staffing requirements.[91]

135. The MFSA is fully cognizant of the resource challenges and has recently improved its remuneration package significantly to help attract and retain talent. Until December 2017, the MFSA had a fixed salary structure where pay raises are only given at promotion, with inadequate recognition given to staff who have performed well. In August 2018, the MFSA revised the compensation structure retrospectively to January 1, 2018, to build in a variable component to reward good performance with salary reviews and performance bonuses. The salary levels were also being adjusted upward, based on benchmarking against three studies conducted by HR consulting agencies. New grades and opportunities for career progression based on experience (in lieu of academic qualification) were also introduced as of August 2018.

136. Concurrently, the MFSA has embarked on a branding exercise to position itself as the employer of choice and enhance its recruitment strategy. Job descriptions for all positions/ grades have been updated based on an established competency framework. It is also diversifying its

[90] The MFSA clarified that while a physical onsite inspection was not carried out, supervisors engaged with third-party service providers via teleconference and Skype; when necessary, they were requested to meet the MFSA in Malta.

[91] Clyde Caruana—Number of foreign workers could increase by 30,000 in the next four years. See: http://www.independent.com.mt.

recruitment sources, including tapping on international candidates. As part of its business process reengineering, there will be greater clarity on delegation of authority and staff empowerment.

Recommendations

It is critical that the MFSA addresses the significant gap in supervisory capacity as an immediate priority:

- The severe inadequacy of the MFSA's supervisory capacity has been reported by both external independent reviews and the IAU. There is also industry consensus that the supervisory effectiveness of the MFSA may be undermined by inadequate resources;

- The inadequate staff resources and inexperienced supervisors will seriously compromise the MFSA's ability to supervise effectively and meet its supervisory objectives;

- This will in turn have implications for the reputation of the MFSA as well as of Malta's financial sector; and

- Unless concerted efforts are made to address this pressing issue, there is risk of a vicious cycle. The expanding workload may result in increased turnover of overstretched supervisors, aggravating the workload of remaining supervisors. The severe resource gap is also well known, which compounds the challenges confronting the MFSA in its recruitment efforts.

Appendix I. MFSA's Supervision and Enforcement Units

Units	Key Responsibilities
Banking Supervision	• Supervising credit and financial institutions.
Conduct Supervision (CSU)	• Securing appropriate protection for financial services consumers. • Supervising trustees, fiduciaries, and company service providers. • Supervising investment services license holders. • Supervising insurance intermediaries and insurance undertakings and credit and financial institutions (pending resourcing of the respective supervision teams).
Insurance and Pensions Supervision (IPSU)	• Supervising insurers, reinsurers, insurance intermediaries, retirement schemes, retirement funds, and related services providers. • Safeguarding the stability of the financial system as a member of the JFSB. **Organized into four functions**:_Actuarial, Compliance, Risk Management, and Regulatory and Legal.
Securities and Markets Supervision (SMSU)	• Prudential supervision of investment services license holders, CIS, recognized private CIS, registered tied agents, recognized administrators, fund managers, market infrastructures (including regulated markets, multilateral trading facilities, and central securities depositaries), and entities within the scope of the European Market Infrastructure Regulation. • Regulating capital markets activities including the admissibility to listing on regulated markets, processing notifications pursuant to the Securitization Act, continuing obligations of listed companies, and market surveillance. • Maintaining the statutes and legislation relating to securities and markets as well as the transposition of EU legislation as required from time to time. • Developing a regulatory framework to achieve effective investor protection, financial market integrity, and financial stability in the field of initial coin offerings, virtual financial assets, and related service providers. **Organized into four teams:** CIS and Investment Firms, Capital Markets and Market Infrastructures, Fintech and Virtual Currencies, and Regulatory and Policy (not yet in place).
Regulatory Development	Research and development as well as implementing cross-sectoral policies, with particular focus on cross-sectoral financial stability oversight, systemic risk monitoring, and macroprudential supervisory issues.
Authorization	• Managing and coordinating the processing of applications for authorization by the various sectoral legislation.

	• Administering cross-border notifications of Maltese finance services licence holders operating in the EU/EEA countries.
Enforcement	• Reviewing the actions and where necessary conducting investigations of license holders for breaches of the law. • Investigating persons carrying on financial services activities without having the necessary license or authorization. • Conducting joint AML/CFT supervision with the FIAU.