THE POTENTIAL IMPACTS OF THE MFSA'S PROPOSED AMENDMENTS TO BANKING RULE 09

Mark Alexander Grimes

The Malta Financial Services Authority (the MFSA) recently closed its consultation process on amendments to Banking Rule 09 (BR09), which primarily relate to non-performing loan (NPL) ratios. Reducing domestic non-performing exposures is a long-term ambition of the Central Bank of Malta (the CBM), though the timing of these amendments should be viewed alongside the European Central Bank's (the ECB) ongoing consultation process on reducing NPL ratios across the EU. In view of this clear national and supranational policy-driven approach, the amendments are very likely to be implemented. However, this article suggests that resolving Malta's gridlocked judicial system would bring greater immediate impact than amending BR09.

The amendments to BR09 give it a more coercive tone. In the MFSA consultation document, the NPL ratio reduction strategy is conceptualised into two stages.[1] In the first stage, credit institutions which are identified as having an excessive NPL ratio (>6%) will be required to develop a reduction plan to be implemented over a period of no more than five years. This plan, and progress against it, will be self-assessed annually by the credit institution and reviewed in parallel by the MFSA and the CBM on an ongoing basis. Key indicators, including the NPL ratio, cure rate and new NPLs, will be reported every six months.

Stage two is effected when, on review by the MFSA, the credit institution is considered as deviating from its NPL reduction plan. In this event, the proposed amendments will create a requirement to allocate capital to a reserve fund. The amount to be allocated is determined by reference to a table shown as follows:

[1] MFSA, 'Consultation on the Proposed Amendments to Banking Rule 9 'Measures addressing Credit Risks arising from the Assessment of the Quality of Asset Portfolios of Credit Institutions authorised under the Banking Act 1994' (*Mfsa.com.mt*, 30 September 2016) <www.mfsa.com.mt/pages/readfile.aspx?f=/files/Announcements/Consultation/2016/Consultation%20Document%20on%20BR09%20(002).pdf> accessed 1 November 2016.

	% of NPLs Past due by less than and equal to 12 months	% of NPLs Past due by more than 12 months
Bucket 3 (>15%)	3.5%	7%
Bucket 2 (NPL 8% - 15%)	2.25%	4.5%
Bucket 1 (NPL 6% - 8%)	1.5%	3%

The overall applicable rate is the weighted average between those NPLs past due by less than twelve months, and those past due by more than twelve months. However, where Common Equity Tier 1 Capital (CET 1) is assessed by the MFSA as being 'high', the allocation percentage will be halved. Interestingly, what level of CET 1 would be sufficiently high to trigger this provision is not specified. Discretion is also made available for the MFSA to alter the percentage to be allocated in those instances where the usual sum would exceed projected earnings after tax.[2]

The Maltese banking circle is small, with a total of 26 currently licensed credit institutions. The seven 'core domestic banks' (CDBs) as defined by the Central Bank of Malta are listed in the table below. These banks represent the majority of loans in Malta. The figures below are compiled from the most recent annual reports of the CDBs, from which it is clear that Mediterranean Bank is the sole entity which would be unaffected by the amendments. The obvious outlier among the CDBs is Lombard Bank, which will need to reduce its NPL ratio by over 25% or €81.7m. Lombard Group's profit before tax was just over €7.8m, so it is difficult to see how it would realistically manage this over the five-year period specified in the amendments.

The remaining banks are generally not so distant from the 6% target as to cause major concern. However, coming soon after the conclusion of the phase-in period for 'Reserve for General Banking Risks' (the General Reserve) in 2015, investors will be frustrated. The reserve, which is maintained at 2.5% of the gross NPL figure, is taken from dividend funds so the prospect of absorbing impairments after having seen dividends drained for the last three years will be unpopular. It is worth noting that the General Reserve must be maintained in addition to any reserve requirements imposable under Stage 2 of these amendments.

[2] MFSA, 'Measures addressing Credit Risks arising from the Assessment of the Quality of Asset Portfolios of Credit Institutions authorised under the Banking Act 1994', (*Mfsa.com.mt*) <www.mfsa.com.mt/pages/readfile.aspx?f=/files/Announcements/Circulars/Banking/2016/BR09%20Amendments.pdf> accessed 1 November 2016.

Core Domestic Bank	Gross Loan Total (mln €)	Gross NPL (mln €)	NPL ratio as % of gross	Date of information	Notes
APS	709.983	62.069	8.74%	December 2015[3]	Ratio calculated from Gross NPL
Banif Bank (Malta)	367.506	32.361	8.8%	December 2015[4]	Ratio calculated from Gross NPL
Bank of Valletta	4,289.370	404.923	9.44%	September 2015[5]	Ratio calculated from Gross NPL
HSBC Bank Malta	3,339.507	233.1	6.98%	December 2015[6]	Gross NPL calculated from ratio
Lombard Bank Malta	326.763	103.044	31.53%	December 2015[7]	Ratio calculated from Gross NPL
Mediterranean Bank plc	593.267	23.430	3.9%	March 2016[8]	Ratio calculated from Gross NPL
Mediterranean Corporate Bank Ltd	N/A	N/A	N/A	N/A	Specific data not available – a subsidiary of Mediterranean Bank plc

[3] APS Bank, 'Annual Report and Financial Statements 2015' (*Apsbank.com.mt*, 2015) <www.apsbank.com.mt/file.aspx?f=3158> accessed 1 November 2016.
[4] Banif Bank (Malta) plc, 'Annual Report 2015' (*Banif.com.mt,* 2015) <www.banif.com.mt/pics/images/Annual%20Report%20-%202015.pdf> accessed 1 November 2016.
[5] Bank of Valletta plc, 'Annual Report 2015' (*Bov.com,* 2015) <www.bov.com/documents/bov-annual-report-2015> accessed 1 November 2016.
[6] HSBC Bank Malta plc, 'Annual Report 2015' (*About.hsbc.com*, 2015) <www.about.hsbc.com.mt/~/media/malta/en/investor-relations/financial-statements/hsbc-annual-report-2015.pdf> accessed 1 November 2016.
[7] Lombard Bank Malta plc, 'Annual Report 2015' (*Lombardmalta.com,* 2015) <www.lombardmalta.com/filebank/documents/LombardAnnualReport2015.pdf> accessed 1 November 2016.
[8] Mediterranean Bank plc, 'Annual Report 2016' (*Medbank.com.mt,* 2016) <www.medbank.com.mt/docs/default-source/investor-relations/annual-reports/mediterranean-bank-plc-annual-report-31-march-2016.pdf?sfvrsn=16> accessed 1 November 2016.

Typical methods of reducing NPL ratios are sale to the secondary market and securitisation, but both of these methods pose problems in Malta. The secondary market is limited by regulation as loan funds are only able to buy loan portfolios of the same type that they are regulated to originate, which does not include loans to households or individuals.[9] The CDBs accounted for 97% of lending to residents of Malta in 2015,[10] of which 43.3% was household mortgages and 7% was consumer credit.[11] Therefore, a significant proportion of the NPL portfolios of these banks will only be saleable domestically to other Maltese credit institutions. Most of these credit institutions have too many NPLs of their own so the purchaser's risk of falling foul of the proposed regulations and the seller's relatively immediate need to reduce exposure will create a difficult pricing environment. There may be appetite within loan funds for the corporate NPLs, though the pricing environment will be equally aggressive for the same reasons. With the likelihood of tighter NPL regulation across the EU in the near future, with potential for an EU-wide glut of NPLs, sale to a foreign bank or fund is possible but seems unlikely.

Securitisation is a better option from a regulatory perspective. A licence is required to offer securitisation to the public but by notification to the MFSA a transaction-specific vehicle can be established without one.[12,13] The essential issue of off-loading poor-quality debt remains though, and the NPLs would need to be packaged with higher quality assets in order to create a viable capital structure. The write-down in value on the offered portfolios and the loss of higher-quality loans would be manageable for most of the banks over a five year period. In the case of Lombard Bank, however, it seems unlikely that a sufficiently robust capital structure could be established to create an investible portfolio. Both securitisation and sale to the secondary market suffer equally from potential market saturation in the five-year period after the amendments are implemented. In Ireland and Italy securitisation with state assistance has some demonstrable success but the political appetite does not appear to exist; the clear intent of these amendments is for the banking sector to shoulder the burden.

Whatever method the CDBs choose to reduce their rations, progress is likely to be slow without solving the problems with the Maltese court system. The CBM in its 2015 Financial Stability Report suggested that both improvements in insolvency legislation and tighter regulation of NPLs would bring systemic benefits[14]. It is a

[9] MFSA, 'Standard Licence Conditions Applicable to Collective Investment Schemes Authorised to Invest Through Loans', (*Mfsa.com.mt*) <www.mfsa.com.mt/pages/readfile.aspx?f=/files/LegislationRegulation/regulation/securities/investmentServices/Revised%20Loan%20Funds%2021_05_2015.pdf> accessed 3 November 2016.

[10] IMF, '2015 Article IV Consultation', (*Imf.org,* 2016) <www.imf.org/external/pubs/ft/scr/2016/cr1620.pdf> accessed 3 November 2016.

[11] Central Bank of Malta, 'Financial Stability Report 2015', (*Centralbankmalta.org,* 2015) <www.centralbankmalta.org/file.aspx?f=31445> accessed 3 November 2016.

[12] Securitisation Act, Chapter 484 of the Laws of Malta.

[13] A vehicle called a Securitisation Cell Company would also be possible but for the purposes of this article it doesn't differ materially from a standard securitisation SPV.

[14] Central Bank of Malta, 'Financial Stability Report 2015' (n 11).

given that ease of enforcement allows higher levels of liquidity. Doing this should be a priority as Malta is internationally renowned for the glacial pace of its courts. In 2010 the average disposition time for a civil or commercial litigation in the first instance was 866 days, with a further average disposition time of 470 days for cases on appeal and yet a further 598 days for cases taken to the highest instance (though some cases will bypass the Court of Appeal).[15] This is unsurprising considering that in 2010 Malta had just 39 judges. One may also note that the combined average disposal time for a case heard in the Court of Appeal is 1,336 days, or 3.7 years, which does not bode well for implementing a five-year NPL reduction strategy by enforcement if this is applicable to insolvency and enforcement proceedings.

Enforcement needs to be recognised as a key element of any NPL reduction strategy. If the banks hold on to their NPLs, they will need to be able to enforce against collateral in order to lower their ratios. If they are to sell or securitise them, the enforcement regime is central to attracting purchasers or investors as it directly impacts on the attractiveness and liquidity of the loans.

Reducing non-performing exposures is often targeted as a method of fostering systemic efficiency, as well as creating liquidity and reducing exposure. However, the MFSA's proposed amendments are likely to exacerbate market concentration and could cause credit rationing. The problems with Malta's courts are chronic and before introducing regulations with the effect of preventing banks from taking risks and tolerating forbearance, the Government should first seek to resolve the serious issues within its own control. If greater speed of enforcement, and a resultant boost to liquidity, can be achieved, the CDBs will not be forced to write off, sell, or securitise as much NPL value – resulting in less of an overall shock to the financial system.

The relatively bold regulatory approach of the MFSA and CBM comes with a clear intent to get loan asset quality well above the European average. Indeed, if Malta wishes to become a financial services hub, it is wise to create legislation now to ensure resilience in the long term. However, tighter regulations are not without their penalties. The more immediate issues are the inevitable costs for the banks and the less forgiving environment for debtors, and as a longer-term casualty the public's access to credit could become restricted.

The CBM and MFSA are following the lead of the ECB. However, Malta is far smaller than other European countries with high NPL ratios. In what is already a small market, market concentration in Malta is only likely to increase if the risk appetite for loans is constrained by regulation, especially if a smaller bank with a stubbornly high NPL ratio which is unable to effect the changes required of it by the legislation was to merge with one of its competitors. In 2015 the CBM identified the

[15] European Commission, 'The functioning of judicial systems and the situation of the economy in the European Union Member States' (*Ec.europa.eu,* 15 January 2013) <http://ec.europa.eu/justice/effective-justice/files/cepej_study_justice_scoreboard_en.pdf> accessed 1 November 2016.

market concentration of the Maltese credit market at 3,388 points on the Herfindahl-Hirschman Index (HHI).[16] The US Department of Justice considers any market with an HHI score above 2,500 to be 'highly concentrated'.[17]

There is little economy of scale to be had in Malta, but as can be seen from the above figures, two of the CDBs represent a very large percentage of the credit market. When risk appetite decreases in pursuit of lower NPL ratios, the space for smaller lenders with greater appetite for risk would normally expand; particularly those banks with sectoral focus. However, if NPLs are capped across the market at a percentage of gross lending, the bigger lenders are favoured by the scale in their ability to offer low-risk loans at better rates. The smaller lenders are less able to compete in the markets for lower risk loans but simultaneously less able to take on risk outside of these markets because of the NPL ratio limit. In this scenario the credit market will concentrate further and move towards rationing. The resultant reduced access to credit will slow overall growth, despite the marginally improved stability of the banks.

[16] Central Bank of Malta, 'Market failures in the Maltese banking sector' (*Centralbankmalta.org)* <https://www.centralbankmalta.org/reports-articles-2015> accessed 1 November 2016.
[17] US Department of Justice, 'Herfindahl-Hirschman Index' *(Justice.gov)* <https://www.justice.gov/atr/herfindahl-hirschman-index> accessed 1 November 2016.