

**Malta: Financial System Stability Assessment,  
including Reports on the Observance of Standards and Codes on  
the following topics: Monetary and Financial Policy Transparency,  
Banking Supervision, Securities Regulation, Insurance Regulation,  
Corporate Governance, and Payment Systems**

This Financial System Stability Assessment on **Malta** was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **July 21, 2003**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of **Malta** or the Executive Board of the IMF.

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## MALTA

### Financial System Stability Assessment

Prepared by Monetary and Financial Systems Department

Approved by Stefan Ingves and Michael Deppler

July 21, 2003

This Financial System Stability Assessment (FSSA) is based on two joint IMF/World Bank Financial Sector Assessment Program (FSAP) missions that visited Malta from October 15 to 25, 2002 and January 27 to 31, 2003. An update was made on the occasion of the Article IV consultation mission May 14–16.

The mission received full cooperation from the authorities and held discussions with the Minister of Finance, the Governor of the Central Bank of Malta, the Chairman/President of the Malta Financial Services Authority, and other government officials. The mission also met with representatives of banks, insurance companies, investment funds, stockbrokers, audit firms, professional association for the financial sector, and other market participants. The mission comprised Piero Ugolini (IMF/MFD, mission chief), Paula Perttunen (World Bank, deputy mission chief), Margarita Aguilar (administrative assistant), Terry Donovan, Sandra Marcelino, Andrea Schaechter, and Mark Zelmer (all IMF/MFD); Laura Ard, Luc Cardinal, Peter Kyle, and Elisabeth Sherwood (all World Bank), Karsten Biloft (Danmarks Nationalbank), and Paolo Corradino (Banca d'Italia). The AML/CFT assessment benefited from the participation of Giulio Sanarighi (Maggiore of the Italian Guardia di Finanza).

Malta's financial system appears to be healthy and well supervised, but very concentrated and exposed to the country's narrow economic base. Financial soundness indicators and stress tests show that the domestic banks are profitable, liquid, and well capitalized. Two domestic banks account for about 90 percent of total assets and if either were to fail, it could trigger a systemic crisis.

Malta has a comprehensive legal framework and strongly adheres to most of the international standards and codes. A new central bank law providing more autonomy to the central bank and officially establishing price stability as the main objective was introduced in October 2002. Malta's legal framework comprises essential elements for AML and CFT.

Notwithstanding, the healthy status of the financial sector, the mission made several recommendations to further strengthen the resiliency of the system, in particular, (a) an effective cooperation between the single regulator for the financial sector and the monetary authority to ensure the financial stability and the soundness of the financial sector; (b) a close monitoring of the quality of the banks' assets and a reduction in the level of NPLs; and (c) a need to specifically criminalize financing of terrorism and provide additional resources and expertise in the AML/CFT area.

The main authors of the report were Piero Ugolini, Mark Zelmer, and Andrea Schaechter.

*FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.*

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## List of Acronyms

AML	Anti-money laundering
CBM	Central Bank of Malta
CFT	Combating the financing of terrorism
CIS	Collective Investment Schemes
CP	Core Principle
CPSIPS	Core Principles for Systemically Important Payment Systems
CPSS	Committee on Payment and Settlement Systems
CSD	Central Securities Depository
CSS	Central Systems of Securities Settlement
DVP	Delivery versus payment
EU	European Union
FATF	Financial Action Task Force
FIAU	Financial Intelligence Analysis Unit
FT	Financing of terrorism
IAE	Independent AML/CFT Expert
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IOSCO	International Organization of Securities Commissions
KYC	Know your customer
LOLR	Lender of last resort
MaRIS	Malta Real-Time Interbank Settlement System
MFP Code	Code of Good Practices on Transparency in Monetary and Financial Policies
MFSA	Malta Financial Services Authority
ML	Money laundering
MSE	Malta Stock Exchange
NPL	Nonperforming loans
PDAC	Public Debt Advisory Committee
PMLA	Prevention of Money Laundering Act, 1994 (as amended)
PMLR	Prevention of Money Laundering Regulations, 1994
RIE	Recognized Investment Exchange
RTGS	Real Time Gross Settlement System
STR	Suspicious Transaction Report
SWIFT	Society of Worldwide Interbank Financial Telecommunications
UN	United Nations

## I. OVERALL STABILITY ASSESSMENT

1. **Malta's financial system is sound and well supervised, but very concentrated and exposed to the country's narrow economic base.** Domestic banks dominate the financial sector. They account for 90 percent of total financial sector assets and have affiliates and subsidiaries in the insurance and securities sectors. Their activities are largely funded by domestic currency deposits from residents.<sup>1</sup> There is also a separate international component of the banking system but it does not appear to be a source of systemic vulnerability. Financial soundness indicators and stress tests suggest that the domestic banks are healthy. The financial system has never experienced a system crisis. However, the limited diversification of banks' loan portfolios, the strong reliance on real estate properties as collateral, some inefficiencies in the judicial system hindering rapid collateral liquidation, and the high concentration of domestic banking activities in two banks weaken the resiliency of the banking system to large economic shocks. The insurance and securities segments are small and not systemically important.

2. **The Maltese authorities have a comprehensive legal framework and strongly adhere to most international standards and codes.** A new central bank law providing more autonomy to the central bank and officially establishing price stability as the main objective was introduced in October 2002. In addition, the supervisory framework has been further strengthened over the past several years to bring it in line with EU standards, and the authorities' capacity to manage the vulnerabilities in the financial system is improving rapidly. A contingency plan designed to help coordinate authorities' action in the event of a crisis in place and a regulation approving the creation of a Deposit Guarantee Scheme and the Investor Compensation Scheme entered into force on January 3, 2003. The level of transparency in monetary and financial policies is generally high, and all institutional elements of an Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) regime are now in place.

3. **Notwithstanding the healthy state of the financial sector and its modern supervisory and regulatory framework, several recommendations were made (Box 1) to further strengthen the financial sector and increase its resiliency to economic shocks.** In the banking supervision area, two of the main recommendations were to encourage the close cooperation and exchange of information between the central bank and the supervisory authority (MFSA) in order to fulfill their statutory responsibilities, and a reduction of the nonperforming loans (NPLs), which are higher than normal EU average. In the latter case, a

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<sup>1</sup> The other banks licensed in Malta are classified by the authorities as "international banks". For the most part, they comprise Austrian and Turkish banks that deal mainly with nonresidents and that were established in Malta for tax purposes. They do not appear to be a source of systemic vulnerability. Malta also operated a specific offshore regime, with lighter regulatory standards, which is being wound down, with the sole remaining bank planning to convert to an "international" licensed bank during 2003.

close monitoring of the asset quality of the banks will be essential. In the area of financial markets, the key issue is to introduce a proper legal and regulatory foundation for the securities settlement system. With regard to AML/CFT, while progress in phasing out the offshore sector is at an advanced stage, recommendations were made to address reputational risk issues, including those related to nominee companies, and Malta's plans for new trust legislation. Additional technical recommendations were made in other areas.

### Box 1. Summary of Mission Recommendations

**The mission identified some areas where authorities' actions would be required to improve the overall supervisory framework and the resiliency of the financial sector.** In particular, the mission emphasized the paramount importance of **maintaining the health and viability of the two largest banks.** In view of the crucial role played by these two banks, it is essential that they be closely supervised and that any required intervention be prompt, in order to avoid systemic crisis. Other recommendations are listed below by sector.

**Banking sector:** Given the high concentration of bank loan portfolios and strong reliance on collateral, banks need to continue holding more capital and provisions than is currently required by the prudential norms so they can, if necessary, absorb shocks that are more sectoral in nature. They also need to continue improving their credit risk management system so that they can monitor exposures and set provisions in a more proactive fashion. A reduction of the NPLs level and a close monitoring of the banks' asset quality will be essential to ensure the soundness of the banking sector.

**Banking supervision:** At the institutional level, the recent establishment of a single regulator for the financial sector has created a new situation in which effective cooperation between the CBM and the MFSA is important to ensure financial stability and soundness of the financial sector. Therefore, it is essential that the two institutions develop a close working relationship to ensure that each institution has access to all the relevant information required to fulfill its statutory responsibilities. To this end, the signing of a formal Memorandum of Understanding (MoU) in February 2003 providing for the creation of appropriate consultative mechanisms is a very important first step. This should go hand in hand with strong cooperation among the officials of the two institutions. On the operational side, a set of recommendations are listed in Section IV.G.

**Payment system:** The recovery time in case of a breakdown should be reduced to less than four hours, the draft contingency plan should be completed and tested, and consideration given to setting up a remote back-up site. The CBM was also encouraged to complete the process of establishing an effective oversight function.

**Securities settlement systems:** The legal framework governing the central securities depository should be improved as its legal status changed in October 2002, when the MSE officially became a recognized investment exchange (RIE). The authorities were encouraged to take steps to address the need for a separate legal and supervisory framework to govern the depository's activities. Such actions should be taken so that Malta's securities settlement system can eventually be integrated with other European systems, and Maltese government securities accepted as collateral in the European System of Central Bank's monetary operations (should Malta eventually join the European Monetary Union). As an immediate priority, the Maltese authorities should make sure that the introduction of delivery versus payment in the securities settlement system moves forward as planned. With regard to the supervision and regulation of the securities depository and settlement system, the MFSA and CBM should cooperate closely and establish their respective roles in an MoU.

**Capital markets supervision:** The MFSA and the MSE need to clearly delineate their respective roles and responsibilities with the aim of optimizing the use of scarce resources and avoiding supervisory, surveillance, and enforcement gaps.

**Box 1. Summary of Mission Recommendations (Continued)**

**Insurance supervision:** Work is also needed to improve the supervision of insurance company internal controls and investment policies. In addition, the MFSA's supervision of insurance company corporate governance procedures should be formalized, and it should move to a more formal risk-based approach to supervision.

**Public debt management:** The CBM's role in the government securities market should be reviewed once the planned primary dealer system is implemented. More generally, the government should continue using its public debt management activities as an instrument to foster a deeper and more liquid secondary market for government securities, and it would be prudent for the government sinking funds to reduce their risk exposure.

**AML/CFT:** The authorities should ensure that the financing of terrorism is fully and specifically criminalized. Moreover, the newly introduced elements of the comprehensive methodology should be swiftly implemented, particularly those relating to the Basel Committee's Customer Due Diligence paper. In relation to nominees (and trustees under the proposed new legislation), financial institutions should be required to verify the due diligence carried out by nominees/trustees, to help to minimize the reputational risk to Malta from the continuation of this category of business. With regard to dealings by financial institutions with other professional intermediaries acting on behalf of clients, information on the identity of the beneficial owner/client should be made available to the financial institution. There is also a need to provide some additional resources and expertise in AML/CFT in the MFSA, increase the frequency of on-site inspections, and extend the coverage to include a sample of domestic branches. As the FIAU develops and becomes more adequately resourced to assist in raising further the level of awareness in the industry, it is expected that some increase in the level of suspicious transaction reports will follow.

**Transparency:** To further increase transparency in monetary policy, the CBM should clarify the objectives and procedures of its operations in the government securities market. Moreover, the CBM should frequently disclose its off-balance-sheet commitments, and issue an annual income statement. Once the payment systems oversight function is established, the CBM should publicly disclose the related policies, objectives, and procedures, and there is a need to disclose the arrangements for information exchange between supervisory and regulatory authorities on the domestic as well as international level.

**A. Financial System Soundness**

4. **The domestic banking sector, which comprises four banks, is dominated by two banks that account for 90 percent of the sector's assets.** The government has a 25 percent stake in one of them, Bank of Valletta. There are no significant links between the domestic and international segments of the banking system described in footnote 1. The Central Bank of Malta's (CBM) financial stability office monitors the financial situation of local large borrowers as part of the Early Warning System.

5. **The Maltese banking system is healthy but exposed to the country's narrow economic base.** Financial soundness indicators indicate that the domestic banks are profitable, liquid, and well capitalized. However, the soundness of the banking system is highly dependent on the financial condition of the two largest institutions and could be undermined in the event of a major economic shock of a systemic nature given the high concentration of banks' loan portfolios and the banks' strong reliance on domestic real estate properties as security in their lending operations. Looking forward, Malta is well placed to benefit from EU accession, albeit banks may face some relevant challenges from increased

competition. This is particularly relevant for one of the domestic banks in which the government is seeking buyers for its 25 percent stake as part of its privatization program.

6. **The insurance and capital market sectors are small and at an early stage of development.** The largest institutions in both markets are affiliated with the two large domestic banks. Although these sectors are fairly small, it is important to emphasize that Maltese residents have significant investments offshore, and a long history of accessing foreign financial institutions to manage their savings.

7. **All remaining business (bank and nonbank) operated under the specific offshore legislation will be phased out by September 2004.** Going forward, all business with non-residents will be regulated on the same basis as for domestic banks and nonbanks. In addition, the complete elimination of regulated nominee company structures is being considered by the authorities under draft legislative proposals, which would also update trust law and provide for regulated trustees, in part with a view to attracting “regulated” international business. While involvement in offshore activities (particularly if widely defined to include all dedicated international financial services businesses) carries with it a reputational risk for Malta, the mission did not observe any additional factors giving rise to particular negative implications for the stability of the Maltese financial system.

8. **The liquidity management framework and the payment systems are sound and not vulnerable to systemic risks.** The CBM manages liquidity by using indirect instruments and has the explicit mandate to provide collateralized liquidity as a lender of last resort (LOLR). The Real-Time Gross Settlement System (RTGS) payment system, which became operational in October 2002, is cost-effective and functions well. The retail payments infrastructure, on the other hand, remains relatively fragmented. However, the authorities and the banks are working on a project to integrate the various systems.

9. **Some relevant vulnerabilities exist in the securities settlement system.** At present, there is no delivery-versus-payment (DVP) for securities transactions. However, significant steps have already been taken to ensure the necessary legal and technical foundation for the introduction of DVP. There is no formal supervision over the central securities depository that is part of the Malta Stock Exchange (MSE). Moreover, since the depository’s legal framework is embedded in the by-laws of the MSE, this could create serious uncertainty in the (unlikely) event that the exchange was to lose its license. The authorities are taking steps to address the need for a separate legal and supervisory framework to govern the depository’s activities.

## **B. Supervision and Regulation**

10. **The authorities have made major efforts in strengthening the supervisory framework in line with international standards and codes.** The Malta Financial Services Authority (MFSA), which supervises the insurance and securities sectors, also assumed from the CBM the responsibility for supervising banks in January 2002. The CBM retains responsibility for supervising the payments system and for monitoring the financial system’s

overall stability through its analysis of financial soundness indicators and the results of its quarterly stress test exercise. Accounting and audit standards are high.

11. **The MFSA's supervision of banks is good.** Over the years, the authorities have made significant progress in creating a supervisory framework that is independent and effective. The most recent and notable steps taken in this regard have been the creation of an independent supervisory agency, and the continued revision of laws and directives to further incorporate EU requirements and overall international best practices. The supervisory effort of the authorities is well supported by qualified and experienced staff who oversee the banking sector through on- and off-site processes.

12. **The MFSA has made considerable progress since 1994 in creating and building an insurance supervision function.** All insurance companies and intermediaries have been inspected at least once since then, and the authorities are currently revising the business forms aimed at enhancing the offsite supervisory framework.

13. **The regulation of the Maltese securities market is presently undergoing a significant transition,** which is expected to be completed in 2003. Recent legislative amendments aim to create a single regulatory authority for the capital market in the MFSA, with the MSE retaining a status of Recognized Investment Exchange (RIE). All regulatory powers have accordingly been placed in the MFSA, and, with the exception of listing requirements, appropriate legislation has been issued. More detailed directives to RIEs were issued in April 2003. An enforcement track record under the new regime still needs to be established.

14. **The authorities' operation of the payments system is good, while further work is needed to improve the securities settlement system.** The CBM operates the RTGS payment system and is working to improve the oversight of the system. Being an integral part of the MSE, it is difficult to separate the function of the Central Securities Depository (CSD) from those of the MSE. As a consequence, there is no direct supervision of the CSD. There are no laws in Malta that address the issues related to the securities settlement process in general and the function of a CSD in particular.

15. **All of the institutional elements of an anti-money laundering regime are now in place in Malta following the recent establishment of the Financial Intelligence Analysis Unit (FIAU).** Malta's legal framework includes the essential components for AML and CFT. However, some points are not covered explicitly in legislation, with reliance placed on interpretations of common law. Financing of terrorism is not yet fully criminalized. AML/CFT implementation measures for all financial institutions regulated by the MFSA are well developed and were observed in practice in banks, securities firms, and insurance entities. For the most part, however, the newly introduced elements of the comprehensive methodology have yet to be implemented.

16. **Monetary and financial policies are conducted in a transparent manner.** The authorities have undertaken considerable efforts to increase transparency and use a variety of

channels for public disclosure, including annual and more frequent reports, press releases, brochures, and speeches by officials.

## II. MACROECONOMIC ENVIRONMENT AND RISKS

17. **Malta's economy is highly dependent on a few sectors, such as tourism and manufacturing, and is, thus, heavily influenced by external developments.** Malta is a small island economy with a population of about 394,000 and a GDP per capita of about US\$9,200 (one of the highest among the EU accession countries). Tourism and manufacturing are the dominant sectors accounting for more than 50 percent of GDP. Electronic products make up three-quarters of manufactured exports. The government's involvement in the economy remains high, notwithstanding the ongoing reform strategy of reducing the government's stake in enterprises. Public administration and state-owned enterprises account for about one-fourth of GDP and employ about one-third of Malta's labor force.

18. **The weak performance of Malta's economy in 2001 and 2002 has slowed credit growth.** The slowdown in the economy has also contributed to raising the levels of NPLs although it is difficult to quantify the exact impact since stricter credit risk management and reclassification of loans following on-site examinations occurred at the same time. Real GDP growth recovered somewhat to 1.0 percent in 2002 compared to a 1.2 percent drop of GDP in 2001, but lies considerably below the growth rates that Malta's economy experienced between 1997 and 2000, which exceeded 4 percent annually (Table 1). The recovery is mostly being driven by the public sector, while the performance of the manufacturing and tourism sectors remain weak.

19. **Strong growth in deposits combined with a slowdown in credit demand has led to a rapid buildup of liquidity in the banking system over the past two years.** Interest rates, which are now fully liberalized, have gradually fallen.

20. **Inflationary pressures from the buildup of liquidity have been modest.** Price developments are mostly determined externally due to Malta's exchange rate peg and the openness of its economy. Moreover, the level of economic activity is still below potential. However, housing prices are rising rapidly because of strong demand. At the same time, balance of payments surpluses have enabled the CBM to build up its level of reserves and strengthen its position to maintain the peg ahead of EU accession. The CBM's level of foreign reserves stood at about 50 percent of GDP or about nine months of imports of goods at end-2002.

21. **The private sector seems well placed to cope with the macroeconomic effects of joining the European Union.** A number of capital account restrictions have already been lifted or relaxed over the past five years. Remaining restrictions on short-term capital flows (in particular loans with a maturity of less than six months) are to be phased out before Malta

Table 1. Malta: Selected Macroeconomic Indicators, 1998–2003

Total population: 397,296 (December 2002)  
GDP per capita: US\$9,740

	1998	1999	2000	2001	2002	May 2003	
<i>Real Sector (in percent)</i>							
Real GDP growth	3.4	4.1	6.4	-1.2	1.0	-1.9	7/
GDP (in millions of Liri)	1,362	1,456	1,562	1,634	1,675	...	
Inflation rate (2002=100) 1/	2.4	2.1	2.4	2.9	2.2	1.3	
Unemployment rate (end-of-period)	5.6	5.8	5.0	5.1	5.2	5.3	8/
<i>Monetary and credit data (end-of-period, percentage change)</i>							
Monetary base	4.3	7.3	3.9	0.6	8.0	8.4	
Money (M1)	9.1	11.0	2.3	6.9	7.0	9.7	
Broad money (M3)	8.6	9.9	4.0	8.4	10.4	6.9	
Domestic credit	10.4	9.6	9.7	6.6	3.3	2.9	
<i>Interest rates (end-of-period, in percent)</i>							
Yield on government bills 2/	5.5	5.0	4.9	4.5	3.7	3.5	
Yield on government bonds 3/	6.0	5.6	6.0	6.1	5.4	5.1	
Bank lending rate 4/	8.1	7.3	7.2	6.5	6.1	6.0	
Stock market index	1,211	3,278	3,376	2,200	1,871	1,922	
<i>Public finances (in percent of GDP)</i>							
Central government financial balance 5/	-10.2	-7.8	-5.5	-5.2	-5.9	-6.8	7/
Total outstanding public debt	56.0	57.6	59.2	61.9	64.3	67.8	7/
<i>Of which: domestic public debt</i>	52.6	54.6	56.7	59.5	61.6	65.1	7/
<i>Of which: external public debt</i>	3.4	3.0	2.5	2.4	2.7	2.6	7/
<i>External sector</i>							
Lira per US\$ (end-of-period)	0.38	0.40	0.44	0.45	0.40	0.37	
Trade balance (in percent of GDP)	-19.1	-18.2	-21.2	-15.6	-13.1	-15.9	7/
Current account (in percent of GDP)	-6.2	-3.4	-13.4	-4.5	-3.9	-11.2	7/
Overall balance of payments (in percent of GDP)	2.8	8.4	-8.5	2.9	3.8	-7.2	7/
Direct Investment, net (in percent of GDP)	7.2	21.3	16.7	7.1	-11.3	0.9	7/
Portfolio investment, net (in percent of GDP)	-2.4	-13.8	-22.0	-12.3	-10.4	-16.3	7/
Gross official reserves (millions of US\$)	1,696	1,794	1,471	1,682	2,209	2,541	
Reserve cover (months of imports) 6/	7.4	7.8	5.2	7.4	8.6	8.4	9/

Sources: Central Bank of Malta; National Statistics Office; and staff estimates.

1/ Twelve-month moving average. 2/ Three-month treasury bills. 3/ Ten-year government securities.  
4/ Weighted average lending rate of deposit money banks. 5/ Figures for 2002 excludes Lm 11.3 million special dividend (0.7 percent of GDP) associated with the MIA privatization process. 6/ Imports of goods.  
7/ Annualized data up to the first quarter 2003. 8/ February 2003. 9/ April 2003.

joins the EU. Levies and subsidies are also being lifted and there are expectations that Malta's economy will remain competitive.

### III. SOUNDNESS AND VULNERABILITIES OF THE FINANCIAL SYSTEM

#### A. Banks

##### Domestic banks

###### *Financial conditions*

22. **The Maltese banking system is healthy but exposed to the country's narrow economic base** (Table 2). Bank profitability, as evidenced by return on assets, has been fairly stable in recent years at around 0.8 percent.<sup>2</sup> The growth of non-interest revenues and expenses has slightly lagged that of total assets. Bank loan portfolios are highly concentrated, notably in loans to the tourism, retail trade, manufacturing, ship repair/shipbuilding, and construction sectors. Although the concentration ratios are not high, in a small economy like Malta, the sectors tend to be more linked and correlated. Banks reported that domestic real estate properties represent almost three fourth of the collateral used as security in lending operations. Lending to nonresidents is insignificant, and more than 95 percent of lending to residents is denominated in Maltese liri.

23. **Domestic banks are currently very liquid.** All four banks' holdings of liquid assets as a share of short-term liabilities comfortably exceed the 30 percent prudential requirement. In light of the significant structural excess liquidity in the banking system, banks do not have a strong need for wholesale money market funding. For funding, domestic banks rely heavily on Maltese liri deposits from residents. Resident foreign currency deposits are not significant.

24. **Maltese banks also show strong capital levels that are well in excess of capital adequacy requirements.** Banks are allowed to take collateral values into account when setting provision requirements. While the banks' discounts on the value of collateral are considered prudent (30 percent discount from appraised value for real estate collateral) from the standpoint of dealing with individual problem loans, experience in other countries indicates that they may not fully reflect the low liquidation values that could ensue if the banks had to quickly liquidate collateral for a wide range of borrowers in the middle of a systemic economic crisis. This is especially true for an economy like Malta's where the economic base is narrow; real estate is the main asset pledged as collateral; there are restrictions on the sale of real estate to nonresidents; and there are some inefficiencies in the

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<sup>2</sup> This compares with an average 0.6 percent return recorded by European banks in 2001, according to the European Central Bank's EU Banking Stability Report (February 2003).

Table 2. Malta: Financial Soundness Indicators for the Banking Sector, 1999–2002

(In percent, unless otherwise indicated)

	Domestic Banks				International banks 1/			
	1999	2000	2001	2002	1999	2000	2001	2002
<i>Capital Adequacy</i>								
Tier I capital to risk-weighted assets	9.5	10.4	10.8	11.9	26.3	28.6	26.7	28.6
Total regulatory capital to risk-weighted assets	14.3	16.0	15.9	16.0	28.0	30.5	28.8	29.9
Capital (net worth) to assets	5.7	6.5	6.7	6.6	18.7	18.1	19.1	19.2
<i>Asset composition</i>								
Sectoral distribution of loans to total loans								
Energy and water	6.9	6.0	5.0	4.9	0.0	0.0	0.0	0.0
Transport, storage, and communication	4.9	5.5	5.7	7.0	0.0	0.0	0.0	0.0
Bank and other financial institutions	2.7	3.1	5.4	4.3	0.9	0.9	1.2	0.9
Agriculture & fisheries	0.7	1.1	0.6	0.5	0.0	0.0	0.0	0.0
Manufacturing, ship repair and shipbuilding	12.5	11.6	10.8	10.0	0.5	0.5	0.4	0.2
Building and construction	5.9	5.7	4.5	4.7	0.0	0.0	0.0	0.0
Tourism	13.2	13.6	13.0	13.3	0.0	0.0	0.0	0.0
Trade	17.4	16.7	15.9	15.5	0.0	0.0	0.0	0.0
Personal loans	21.7	22.1	24.5	27.2	0.0	0.0	0.0	0.1
Other:	14.1	14.6	14.6	12.7	98.6	98.6	98.4	98.8
<i>Of which:</i> Nonresidents	0.5	0.5	1.1	1.3	98.2	98.1	98.0	98.6
Loans in foreign currency to total loans 2/	6.1	5.0	4.6	4.2	100.0	100.0	100.0	100.0
NPLs to Gross Loans 3/	13.0	14.0	18.0	16.2	0.1	0.1	0.4	0.8
Large exposures to Tier 1 capital 4/	319.3	195.3	257.0	232.9	142.4	211.6	185.0	218.2
Gross asset position in derivatives to capital	92.9	66.2	95.5	115.0	24.1	11.5	1.4	1.4
Gross liability position in derivatives to capital	65.7	57.7	51.5	84.9	25.0	11.7	1.4	1.4
<i>Earnings &amp; profitability</i>								
ROA (before tax)	0.9	0.8	0.8	0.8	6.0	4.0	3.4	1.7
ROE (before tax)	15.7	13.3	11.9	12.3	27.9	21.7	18.3	8.8
Interest margin to gross income	68.2	69.4	70.4	70.8	81.6	74.4	80.3	0.4
Noninterest expenses to gross income	60.0	59.9	59.8	72.7	57.1	58.7	21.2	18.1
Personnel expenses to noninterest expenses	59.8	60.6	57.5	48.2	3.8	3.4	19.5	32.0
Trading and fee income to total income	12.6	11.3	11.7	14.2	-21.0	0.1	10.2	23.4
<i>Liquidity</i>								
Liquid assets to total assets 5/	22.9	20.6	25.0	24.8	29.0	22.5	38.1	24.6
Liquid assets to total short-term liabilities 5/	41.1	36.6	46.6	45.1	61.5	64.7	101.4	85.4
Customer deposits to total (non-interbank) loans	139.4	131.9	144.8	162.7	55.3	69.6	73.4	43.7
Liabilities in foreign currency to total liabilities 6/	27.9	27.4	29.4	30.5	96.8	95.0	96.0	97.7
<i>Sensitivity to market risk</i>								
Average repricing period of assets (in years) 7/	n.a.	2.5	2.8	2.5	n.a.	1.6	1.4	1.4
Average repricing period of liabilities (in years) 7/	n.a.	1.0	0.7	0.7	n.a.	1.8	1.3	0.7
Net open positions in FX currency to capital	15.1	16.3	16.3	17.1	n.a.	n.a.	n.a.	n.a.
Net open positions in equities to capital	34.8	31.2	26.8	28.0	4.7	5.2	1.8	3.1

Sources: Central Bank of Malta.

Note: n.a. = not available.

1/ Exclude branches.

2/ Data relating to loans in foreign currency includes lending denominated in external liri.

3/ Data relating to gross loans excludes interbank lending. **In March 2003 the ratio fell to 15.3 for the domestic banks.**

4/ Exposure equals to or exceeding 10 percent but less than 25 percent of the bank's own funds on a net basis.

5/ Liquid assets include cash, central bank balances, excess reserves, T-bills, interbank claims, and marketable debt securities.

6/ Data include foreign securities sold under agreement to repurchase and foreign subordinated loan capital.

7/ Repricing of assets and liabilities include on-balance sheet items only.

judicial system that may hinder the banks' ability to obtain ownership of collateral in a timely cost-effective basis. The mission strongly recommended that the authorities reduce the level of NPLs and strictly enforce the new loan classification and provision requirements introduced in 2001.<sup>3</sup> And, as also indicated by some rating agencies, to be vigilant on the quality of the banks' loan portfolios. **In this context, the mission welcomes the CBM's initiative to begin publishing aggregate NPLs data.**

*Stress testing*

25. **The CBM introduced a quarterly stress testing exercise in 2002 to assess the four domestic banks' ability to cope with various economic and financial shocks.** The mission relied on these stress tests, and supplemented them with an examination of the banks' ability to absorb changes in the average credit quality of their domestic loan portfolio and securities holdings (Box 2). The international and offshore banking institutions operating in Malta were not included because they do not represent a source of systemic risk.

26. **Stress tests for credit risk clearly illustrate how the domestic banks' financial condition is significantly influenced by Malta's narrow economic base.** While banks can readily manage their exposures to individual borrowers, they might have difficulty in coping with shocks that are more systemic in nature due to the limited diversification of their loan portfolios and their reliance on real estate property as collateral in lending operations. Collateral valuations appear to be a major determinant of banks' abilities to weather a deterioration in the average quality of their credit exposures. Given the large indirect exposure to real estate property prices, the authorities should remain vigilant in their appraisal of real estate collateral. The introduction of a real estate price index will be important in this endeavor and for conducting stress tests.

27. **The credit risk stress tests also indicated that the banks' credit risk management systems could be strengthened further.** Although the two largest banks have implemented credit scoring systems, they need to consider further refinements to their systems that would enable them to assess the implications of their economic outlook for future loan losses, and to provision accordingly in a proactive manner. The two smaller banks have yet to introduce formal credit scoring systems.

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<sup>3</sup> NPLs are classified by past-due and risk criteria. A loan is considered to be nonperforming when it is overdue by 90 days or when there are other reasons to believe that there is doubt as to the collectibility of funds.

## Box 2. Malta: FSAP Stress Test Exercise

### Credit risk

It was not practical to conduct a “top-down” stress-testing exercise linking the quality of bank loan portfolios to macroeconomic developments for two main reasons. First, the managements of the two largest banks have undergone significant changes. Second, the rules governing credit classification and loan loss provisioning have been significantly revised, undermining the usefulness of a time-series analysis. Therefore, the analysis of credit risk was limited to a forward-looking, “bottom-up” approach that was based on scenario analyses and international rules of thumb.

**Exposures to key sectors and large borrowers:** Given the highly concentrated nature of bank loan portfolios and close links between economic sectors, the first step was to examine the domestic banks’ capacity to absorb a default by key economic sectors and sub-sectors. This was done by examining their gross exposures to these sectors/sub-sectors relative to their capital base under the extreme scenario that there would not be any collateral available to secure the credit exposure.

Consistent with the high degree of concentration in bank loan portfolios, the results suggest that the banks would be most at risk from private sector defaults in the wholesale and retail trade sector and the household sector. A default by any one of these sectors would result in all four banks needing to raise new capital to meet prudential requirements. Not surprisingly, the banks are in a better position to weather a default of a sub-sector or a large borrower. However, they would be vulnerable if the government defaulted on its debt since government securities and contingent liabilities arising from guarantees represent more than 30 percent of bank holdings of loans and securities.

**Capacity to withstand downgrades in credit quality:** The effect of a downgrade in the average credit quality of the domestic loan and securities portfolios on the capital of each domestic bank was assessed. Banks were asked to allocate their private sector claims into credit rating buckets that broadly correspond to Moody’s credit ratings. Since the government’s domestic debt is rated single-A by Moody’s, all other credit exposures were rated Baa or below. The expected loss of the total portfolio was then computed using the default probabilities associated with Moody’s credit ratings.<sup>1</sup> The stress test then explored the effect on each bank’s expected credit loss from a downgrade of one and two full grades. However, it was not possible to assess the likelihood of a credit rating change of one or two full grades in the Maltese context.

The stress test results indicate that most of the banks should be able to cope with a decline of one or two full grades in the average credit quality of their private sector exposures. Expected losses in each scenario were less than the sum of their accumulated provisions and collateral pledged by borrowers. The banks’ ability to weather a credit quality decline, however, is very dependent on their being able to liquidate the underlying collateral at a price close to the reported “discounted value” in the event of default.

### Market risk

**Interest rate risk:** Interest rates have been fairly stable in Malta over the years, reflecting in part the interest rate controls that were mostly lifted in the mid-1990s and completely eliminated in 2000. Hence, historical experience could not be used to select plausible interest rate shocks. Instead, interest rate risk was assessed using arbitrary parallel shocks to the yield curve of +/-100, and +300 basis points. The four domestic banks were asked to compute the effects of these shocks on their pre-tax profits using their own internal risk management systems, which are largely based on standard repricing gap analysis. The results suggest that three banks are positioned to profit in the first 12 months from an increase in domestic interest rates. The fourth one has more than enough capital to absorb an interest rate increase without falling below prudential requirements.

**Foreign exchange risk:** As with interest rates, the stability of Malta’s exchange rate regime meant that past exchange rate movements could not be used to set plausible exchange rate scenarios. Instead, exchange rate risk was assessed using arbitrary shocks of +/- 10, 20, and 50 percent to the value of the Maltese lira against the individual currencies that make up the currency basket (euro, pound sterling, and the U.S. dollar).

Given the tight prudential limits imposed by the MFSA on the banks’ open foreign exchange positions relative to capital, all four banks are well positioned to cope with the direct effects of exchange rate movements. Net open foreign exchange positions in aggregate are not allowed to exceed 20 percent of bank capital, and there are limits of 5 percent on each individual currency exposures (except the euro, where there is a 14 percent limit, since it represents 70 percent of the currency basket). Since all four banks operate with small positive net open positions in foreign currencies, their profits would only decline if the Maltese lira appreciated against the basket currencies. However, given that their net open foreign exchange positions are small, capital adequacy ratios for each of the four banks would stay above the eight percent threshold under all of the scenarios considered.

<sup>1/</sup> Probabilities of default were constructed using the Moody’s historical transition data for the United States (1980–1999). Rating qualifiers were disregarded for purposes of this exercise. Expected losses equaled gross exposures times’ probability of default. Thus, expected losses would broadly compare to total accumulated provisions recorded on banks’ balance sheets if a zero recovery rate is assumed and no allowance is made for collateral in the event of a loss.

28. **Stress tests for market risk suggest that banks are well positioned to cope with shocks to interest rates, foreign exchange rates, and equity prices.** Except for one small bank, all banks would profit from an increase in domestic interest rates over a horizon for up to 12 months, although profits would decline over the longer run in the absence of changes to their balance sheet structures, since their holdings of longer-term fixed-rate securities represent more than one third of their assets. That small bank, however, seems to have more than enough capital to absorb the tested shocks without falling below prudential requirements. The stress tests also indicate that all four banks are in a position to cope with the direct effects of exchange rate movements given the tight prudential limits imposed by the MFSA on the banks' open foreign exchange positions relative to capital. All banks would benefit from an appreciation of these currencies against the Maltese lira. The banks' exposure to unexpected movements in equity prices is manageable, since equities represent less than 30 percent of capital. Stress tests on market risks incorporate derivative positions that are used to offset balance sheet exposure.

### **International banks**

29. **The international banks operating in Malta have no significant linkages to the domestic financial system and therefore do not pose any systemic risks.** Most of them rely on funding provided by deposits from foreign banks (notably parents/affiliates) and nonresident deposits obtained in part through parent banking groups. Their assets are primarily invested in deposits of foreign banking institutions (in many cases related affiliates), foreign securities, and loans to nonresidents (especially those sourced through their parent's global banking networks). As per agreement with the Maltese authorities, weak loans do not remain on the books of the Maltese entities, but are instead transferred back to the foreign parent. None of these banks has encountered any difficulties.

### **B. Insurance Companies**

30. **The insurance sector is very concentrated, while being indirectly linked to the banking sector.** One local group of insurance companies (Middlesea), which is affiliated with Bank of Valletta and owned in part by the Maltese government, dominates the insurance market and its failure would pose a risk for the systemic stability of the insurance sector. However, the direct links between the insurance and banking industries are limited.<sup>4</sup>

31. **The insurance sector is profitable, with insurers complying with solvency margin requirements even though profitability ratios are on the decline.** The sector is also very conservative in its provisioning, and reinsurance is kept to a reasonable level. Provisions have increased gradually in recent years.

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<sup>4</sup> Bank of Valletta, plc, (an upstream bank holding company) is a shareholder in Middlesea (non-life) and Middlesea Valletta (life) insurance companies. Insurance companies' funding through bank loans is insignificant.

### C. Capital Markets

32. **An important issue revolves around the role of the CBM as market maker in the government securities market.** Given the absence of private market-making facilities, the CBM quotes daily bid and offer prices to guarantee liquidity to MGS holders and to stimulate trading in this market. The CBM's pricing policy seeks to be market-driven and is entirely independent of the monetary operations framework. The CBM has been consulting for a number of years with the main market players with a view to encouraging them to take over the market-making role. However, the narrow spread between its prices may have inhibited other participants from becoming market makers. The CBM was encouraged to consider reducing its presence in the market once a system of primary dealers has been implemented.

### D. Payment and Settlement Systems

33. **The MaRIS system exhibits no major weaknesses, observing most of the CPSS core principles.** The number of failed payments has dropped significantly from the days after implementation and has currently reached an acceptable level of less than five per day. However, the system is relatively new and all procedures are not yet in place and tested. Some technical issues that should be addressed by the CBM are the relatively high minimum four hours recovery time in case of breakdown, and the lack of a remote back-up site. Moreover, it is important that the CBM develops and tests contingency plans, especially if the system is extended to more members in the future.

34. **Given the size of the Maltese economy, the retail payments infrastructure could be better integrated to become more efficient** by creating a single retail system, which can handle several means of payment.

35. **While the present operational arrangements for the Central System of Securities Settlement (CSS) and the CSS functions in the MSE are appropriate for the nature and size of the domestic market, there are some uncertainties surrounding the role, regulation, and supervision of the CSD.** Being an integral part of the MSE it is difficult to separate the function of the CSD from those of the MSE. As a consequence, there is no direct supervision of the CSD. Ensuring that the CSD has a well-founded legal basis, including finality of securities transactions, should be a priority. At the same time, the authorities should consider placing the CSD in a separate entity. With regard to the supervision and regulation of the securities depository and settlement system, the MFSA and CBM should continue to cooperate closely and establish their respective roles through MoUs.

36. **The Maltese authorities should ensure that the planned steps to introduce DVP in the Maltese securities settlement system are implemented as soon as possible.** Presently in Malta, securities are transferred on the day of trade, while the funds are transferred three days later.

## E. Systemic Liquidity and Monetary Management

37. **The CBM uses four instruments to manage banks' short-term liquidity needs—reserve averaging, foreign exchange operations, repo operations, and the marginal lending facility.** The system of required reserves allows full averaging over the one-month holding period. Required reserves are remunerated at a fixed rate of 2.7 percent, which is below market rates. The CBM also stands ready to buy and sell spot foreign exchange in the three basket currencies. Should the entire banking system be short of liquidity, the CBM would inject liquidity through weekly auctions of repurchase agreements with government securities. The collateralized marginal lending (stand-by) facility can be automatically activated to provide overnight loans if a bank account is overdrawn at the end of the day or upon request of banks for up to 12 months. The new MaRIS payment system ensures that, at any time, payments are settled only if enough collateral has been pledged to the CBM. During the day, a lack of funds in a bank's settlement account would result in an intra-day loan; such a loan at the end of the day is accounted for as an overnight loan and is charged a penalty interest rate.

38. **The CBM only accepts government bonds as collateral for CBM loans.** Dematerializing treasury bills and introducing the European Master Repurchase Agreement would not only make them more usable as collateral, it would also make the treasury bill market more accessible to foreign investors and encourage the development of an interbank repo market.

39. **In the current situation of excess liquidity, the CBM manages liquidity through weekly auctions of deposits with a maturity of two weeks in order to accommodate the entire demand for those deposits.** The CBM's overnight deposit facility, which is remunerated below market rates and below the rate of remuneration for required reserves, is typically accessed only on the last day of the reserve maintenance period. The CBM produces daily liquidity forecasts but focuses mostly on the days of the auctions of term deposits or repos. The liquidity forecasting process could be improved by including daily/weekly government cash-flow projections that the Ministry of Finance (MoF) would produce under a new cash-flow management system.

40. **The CBM has an explicit mandate to provide liquidity as a lender of last resort to safeguard the financial stability of the system.** In such circumstances, it can grant collateralized loans to any bank incorporated in Malta against such forms of security as the Board may consider appropriate. The previous recommendations to dematerialize treasury bills and strengthen risk controls are also applicable for strengthening the use of the LOLR facility.

## F. Public Debt Management

41. **Malta's public debt management practices are not a source of systemic risk to the financial system.** The debt stock is conservatively managed, as most of it consists of longer-term fixed rate securities denominated in Maltese liri. This leaves the government's

debt service costs well protected against any unexpected sharp fluctuation in interest rates or a significant exchange rate depreciation.

42. **The institutional structure governing public debt management activities, however, is at an early stage of development.** Activities surrounding the management of the debt stock are scattered across several government agencies, including the MOF, the CBM, and the Accountant General's Office. These activities are coordinated by the Public Debt Advisory Committee (PDAC), which consists of senior officials from each of these agencies plus one from the MSE. The authorities are obtaining technical assistance from the Commonwealth Secretariat to help them create a debt management office to centralize the day-to-day debt management activities, and transform PDAC into a group that focuses on strategic issues. Over time, they also plan to introduce more formal risk management procedures so that they can monitor and manage the financial risks embedded in the debt stock in a more rigorous fashion and ensure debt sustainability. One area, which requires close attention, however, is the management of the large stock of guarantees. As state enterprises are privatized over time, any associated guarantees should be either extinguished or priced appropriately.

43. **The authorities were also encouraged to follow through with their plans to take a broader view of public debt management, using it as an instrument to help develop more liquid domestic capital markets over the medium term.**<sup>5</sup>

## G. The Supervisory and Regulatory Framework

### Banking supervision and regulation

44. **The authorities' compliance with the *Basel Core Principles for Effective Banking Supervision* is good.** While the structure of the MFSA is clearly established, the internal governance process should be more explicit and further developed. The Supervisory Council, represented by the Director General and the heads of each arm of supervision, is responsible for licensing decisions and for monitoring and supervision of entities licensed by the MFSA. The review of this body's oversight function and of the information flows it receives disclosed the need to have more developed rules of procedure. The Council, being responsible for key supervisory decisions, must ensure that it receives timely and comprehensive information on the status of supervised entities, particularly if deteriorating trends or problems are detected, so that it may effectively execute its responsibility and make well-informed decisions. Similarly, the supervisor should further emphasize sound

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<sup>5</sup> The Guidelines for the Public Debt Management, developed by the IMF and World Bank, and the Accompanying Document to those Guidelines provide guidance and country examples on these issues ([www.imf.org/external/np/mae/pdebt/2000/eng/index.htm](http://www.imf.org/external/np/mae/pdebt/2000/eng/index.htm)).

governance in the industry by explicitly holding boards accountable for the condition and performance of their banks.

45. **Supervisory enforcement and corrective action are also key areas requiring attention.** In the past, the supervisor has made active use of “moral suasion” in problem situations. While this resulted in gradual corrective action, it also involved some delay to elicit response. In cases where a supervisory response is needed in order to address poor bank management or to arrest unsafe and unsound activity, the supervisor should ensure that definable actions are taken promptly.

46. **There is currently no legal provision requiring the supervisor to take prompt corrective action (PCA) based on certain evolving and existing conditions.** Consideration could be given to developing a PCA provision that requires the supervisor to take gradually increasing remedial action when certain conditions exist. Also, the supervisor should have some form of written formal agreements or memorandum of understanding in the case of significant problems, not necessarily exclusively based on capital impairment. An amendment to the Banking Act or other legislation may be necessary to ensure the enforceability of such regulatory directions. Furthermore, the magnitude of monetary penalties for breaches of regulation may not have the desired impact and the penalty structure should be revisited.

47. **Increased emphasis on the overall assessment of banks’ internal risk management systems and the methods (accuracy and effectiveness) of risk measurement, monitoring, control and reporting should be elevated to a higher level.** The credit risk instructions provided in the Banking Directive 09 are generally adequate, however there is an opportunity to strengthen classification and provisioning guidance.

48. **Additional focus is also needed on collateral valuation and the subsequent credit given to it in the classification and provisioning process.** Currently, full credit is given to collateral values when making loan provisions. No guidelines or directives are in place to address acceptable collateral valuation processes. This is particularly important, as there are legal impediments to efficient foreclosure and liquidation actions. Without rigorous collateral valuation guidelines and given the dependence on collateral to support required loan loss provisions, the accuracy of classifications and loan loss provisions could be potentially questioned.

49. **The supervisory process and the examination technique practiced by the supervisors are good.** However, there is a need to enhance the impact, the accuracy, and the timeliness of examination results through several steps.

50. **Capital adequacy figures reflecting examination classifications and provisioning results should be presented in the reports of examination and be included in the supervisor’s monitoring systems and documentation.** If material misstatements of financial position have been made by the bank based on these results, any pertinent violations of law and supervisory actions should be triggered.

51. **The appropriate legal provisions are in place to allow information sharing and reciprocal cooperative agreements with foreign supervisors.** However, no MoUs are yet in place. The supervisor should continue to pursue communications with foreign supervisors in order to further establish its reputation as an effective and transparent regulator, thereby enhancing the reputation of the Maltese banking system. Efforts to formalize cooperative agreements with the pertinent authorities should continue.

#### **Insurance supervision and regulation**

52. **The authorities have made significant progress in creating an effective insurance supervisory framework and comply with most *IAIS Core Principles*, but some areas need further strengthening.** In particular, (a) the MFSA should formalize insurance company corporate governance procedures; (b) work is needed to move to a more formal risk-based approach to supervision; and (c) a consistent approach in the respect of exchange of information with foreign insurance supervisory authorities should be developed.

#### **Securities markets supervision and regulation**

53. **Observance of *IOSCO Objectives and Principles for Securities Regulation* is good.** However, given the extent of the recent legislative reform, it is too early to assess the enforcement track record under the new regime. The MFSA's new supervisory and regulatory responsibilities are likely to place serious strains on MFSA staff resources given the mismatch between the large number of regulatory subjects and the number of staff in the MFSA Investment Services Unit. The enforcement powers are appropriate and well established in law, and the established enforcement practices to date also seem appropriate. The statutory capital requirements of the stock trading and investment services firms should be risk-adjusted.

#### **Payment systems**

54. **The CBM, which is the competent authority in the area of payment systems, shows a strong observance of the *CPSS Core Principles for Systemically Important Payments System*, although further work is needed to improve the securities settlement system.** According to the Central Bank of Malta Act, no person should organize, establish, operate, and participate in a domestic payment system unless such system is approved and authorized by the CBM.

### **H. Transparency of Monetary and Financial Policies**

55. **The CBM has made significant efforts to improve the transparency of monetary policy and observes most of the transparency practices outlined in the *Code of Good Practices for Transparency in Monetary and Financial Policies*.** In this context, the amended CBM Act, which came into effect in October 2002, is in line with EU requirements. The amended Act focuses monetary policy on the pursuit of price stability, reinforces the

independence of the CBM, and clarifies the CBM's role in fostering financial stability. In the transparency area of monetary policy, the main shortcomings of the central bank in this area of transparency relate to the lack of clarity in the description of the objectives and procedures of the CBM's operations in government securities markets, and the lack of monthly information about the CBM's off-balance sheet commitments, especially its forward contracts in the foreign exchange market. Improvements in the transparency of financial policies should be made by clearly defining and publicly disclosing both (i) the roles of the MFSA and CBM in regulating and supervising the securities depository and settlement system, and (ii) the arrangements for the exchange of information between domestic as well as international supervisory and regulatory authorities.

### I. Legal Framework and Judicial System

56. **Malta has a sound and well-established legal system that is based upon a unique combination of civil and common law provisions and principles, which have been successfully blended to accommodate the country's history and traditions.** Respect for the rule of law, the judiciary and the legal profession is high. The courts are regarded as responsive to the needs of the people although delays in the resolution of commercial cases are widely regarded as excessive.

57. **The financial sector laws and regulations are comprehensive in scope, well drafted and consistent with international best practices.** Following the decision to move to a single regulator, the financial sector reforms that were introduced between 1994 and 1998 have been substantially revamped in the last two years and brought into line with EU norms and directives and international standards. New legislation covering the banking, securities, insurance and anti-money laundering sectors is now in place or about to be enacted. The pace and scope of reform is impressive and the authorities are to be commended for their readiness to adjust the country's legal and institutional framework to reflect external developments without compromising its essential legal traditions. The result is that Malta has a legal framework that is responsive to the needs of the international financial and business community. Modern securities market legislation has been enacted that is in line with European practice.

58. **The collateral/debt enforcement provisions are satisfactory but implementation tends to be more problematic.** The land registration system appears to work well, although significant areas of Malta are still not subject to individual title. The company register is highly efficient and accessible on-line. The only significant area of concern relates to what is widely regarded as excessive delays in resolving court cases. In this context, the one area that merits review is the speed at which commercial cases are resolved and judgments are successfully enforced. The insolvency regime is comprehensive although it lacks a corporate restructuring, that is, the development of a "Chapter 11"-type facility. This change is under consideration. Reforms in this area may be required to ensure that the business community retains respect for the courts as the primary dispute resolution mechanism.

## **J. Financial Stability Policy and Safety Nets**

59. **Malta's banking system has never experienced a systemic crisis. However, a contingency plan exists and is in the process of being refined.** The plan is designed to help coordinate authorities' action in the event of a crisis. Based on the classification of the severity of the crisis, a set of possible responses is prescribed in the plan. As a part of these actions (as well as on an ongoing basis), coordination and exchange of information with the CBM is required. The Financial Stability Office of the CBM is in the process of developing an Early Warning System, based on the prudential returns of the reporting institutions. This system includes the monitoring of the local large borrowers' financial situation by means of the examination of their financial statements and banking exposures. This is related also to the situation that no rating agencies operate in Malta. The Financial Stability Office produces a stability report that analyses the banks credit risk management issues and the trends of nonperforming loans and provisions. These analyses are discussed on an informal basis with MFSA, with which regular contacts and exchange of information are in place. A permanent MOU between the MFSA and CBM, covering also coordination issues in the event of a banking crisis, was signed on February 4, 2003. Under this new MoU, the CBM will be responsible for the maintenance of the database, which comprises statistical and prudential information sent by the reporting institutions.

60. **The legislative amendments enabling the setting up of a Deposit Guarantee Scheme and the Investor Compensation Scheme were approved by Parliament in July 2002.** The new regulation, which provides the legal basis for the scheme, entered into force January 3, 2003. The scheme is being developed along the lines of EU standards. It will be under the general control of a Management Committee, recently appointed by the MFSA, and is a corporate body having a distinct legal status. Apart from special circumstances (winding up by the Court or voluntary winding up), the MFSA has the power to trigger the activation of the scheme within 21 days from the day that any particular credit institution is unable to meet its obligations arising from claims by its depositors. The sources of funding for the scheme will include contributions from participants, and other sources.

61. **Every credit institution that is licensed in Malta under the Banking Act shall participate in the scheme, including a branch of a credit institution operating in another country.** The total amount of compensation that may be paid out to any depositor shall be the lesser of 90 percent regarding that depositor's eligible deposits, or up to the Maltese equivalent of EUR 20,000, in line with the EU minimum level of protection.

## **K. Anti-Money Laundering and Combating the Financing of Terrorism**

62. **The authorities in Malta have long recognized the importance of an effective AML/CFT regime and have demonstrated a strong commitment to fulfilling their international obligations in this area.** The legislative framework, first enacted in 1994, has been updated and strengthened on several occasions, most notably in 2001/02. The authorities have played an active role in international fora and in the development of international AML/CFT standards.

63. **Malta has put in place a legal framework which is comprehensive, well established and broadly consistent with international standards.** It has signed, ratified, and adopted most of the key international conventions, treaties, and UN Resolutions relevant to AML/CFT and is committed to achieving full compliance. No major legislative or regulatory gaps have been identified although, as the authorities acknowledge, in order to achieve full compliance with the legal and institutional aspects of the methodology, some technical refinements will be required in the current regulations and guidance notes. In this respect, for example, the issue of whether the financing of terrorism has been adequately criminalized needs to be further considered. In addition, a number of specific aspects from the Basel Committee's *Customer Due Diligence* paper, relating in particular to the implementation of measures for high-risk customers, need to be incorporated into the regulations or guidance notes, as appropriate.

64. **All of the institutional elements necessary to support an effective AML/CFT regime are in place, following the establishment of the FIAU, which became fully operational in October 2002.** It is not feasible at this early stage of its operation to assess in detail the effectiveness of the FIAU. However, the Unit is expected to be in a position during 2003 to satisfy the requirements for membership of the Egmont Group of financial intelligence units. The current level of Suspicious Transaction Reports in Malta appears low by international comparison. With the creation of the FIAU, it would be expected that increasing awareness in the financial system could result in a significant increase in reporting. The level of resources available to the FIAU should be kept under review to ensure that it is adequate to meet growing demands on its expertise.

65. **The implementation of the AML/CFT regime has been integrated into the ongoing supervision of all regulated institutions.** While the FIAU is the designated competent authority for AML/CFT, the MFSA, as single regulatory authority for banks, securities firms, insurance businesses, and bureaux de change carries out a program of on-site and off-site supervision into which AML/CFT is incorporated. It is recommended that the level of resources and specialist expertise in the area of AML/CFT in the MFSA should be reviewed and increased as necessary to expand the program of on-site inspections to include, in particular, the international banks and a sample from the branch network of the domestic banks. A high standard of awareness, acceptance, and implementation of the AML/CFT provisions has been observed in the course of the mission in a range of regulated institutions.

66. *In the area of law enforcement, the explicit introduction is recommended, equally for drug and non-drug related investigations, of all possible investigative measures on ML/FT in the work of the police. Consideration should be given to the development of specialist expertise within the Economic Crimes Unit of the police in the areas of CFT and AML analytics.*<sup>6</sup>

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<sup>6</sup> Assessment of criminal law enforcement measures was conducted by an expert not under the supervision of Fund and Bank staff. Portions of the assessment attributable to him are shown in italicized text.

67. **When reviewing the current regime for nominees, particular attention should be given to risk control in the area of AML/CFT.** It is acknowledged that nominees are regulated in their own right by the MFSA and are required to apply customer due diligence procedures. However, for such business, which is high-risk and with potential reputational implications for Malta, additional measures are recommended with respect to financial transactions of nominee companies. In particular, current bank identification requirements should be extended to require the independent application by regulated financial institutions of full customer identification procedures, as are applied to customers generally. The same recommendation would apply equally to the proposed amendments to the trust regime. While the strengthening of regulatory requirements in the current draft legislative proposals is to be welcomed, they cannot be assessed in detail at this time, since the associated regulations have yet to be drafted.

## FINANCIAL SYSTEM OVERVIEW

### A. Institutions

#### The banking sector

68. **The banking sector is by far the largest segment of Malta's financial system (Table 3).** It also dominates the insurance and securities industries, through subsidiaries and affiliates in these sectors. It consists of a domestic and an international component that operate independently of one another. The domestic component is highly concentrated, and consists of four banks. The two largest are roughly the same size. They dominate the sector, representing more than 90 percent of domestic system assets, with similar shares of the deposit and loan markets for residents. The two large banks also dominate the insurance and securities industries, through subsidiaries and affiliates in these sectors. Maltese bank profit margins and operating expenses are broadly comparable to those in the EU.

Table 3. Malta: Financial System Structure, 1998–2002

	Dec-98		Dec-99		Dec-00		Dec-01		Dec-02	
	Number	Assets (Liri mill.)								
Deposit money banks	5	2,647	5	2,937	4	3,187	4	3,590	4	3,911
Private	4	2,647	5	2,937	4	3,187	4	3,590	4	3,911
Domestic	4	2,647	3	1,629	3	1,836	3	2,028	3	2,238
Foreign	0	0	2	1,308	1	1,351	1	1,562	1	1,673
State-owned	1	n.a.	0	0	0	0	0	0	0	0
International banks 1/	9	1,892	11	1,856	14	2,186	10	1,868	9	2,835
Offshore banks	4	n.a.	4	670	4	859	3	765	1	n.a.
Insurance companies 2/	28	152	26	186	24	215	21	251	21	n.a.
Life	6	83	6	114	6	142	5	168	5	n.a.
Nonlife	22	70	20	71	18	74	17	82	16	n.a.
<i>Memorandum item:</i>										
Nominal GDP		1,362		1,456		1,558		1,630		1,685

Source: Central Bank of Malta, and Malta Financial Services Authority.

1/ Total assets for December 2002 includes one offshore bank.

2/ The three insurance companies that are composite have been grouped in the category of their major business. The subtotals of life and non-life companies do not sum up to the total insurance companies.

69. **The international component consists of 10 international banks and 1 remaining offshore bank that deals mainly with nonresidents in foreign currency.** The international banks mainly consist of branches and subsidiaries of Austrian and Turkish banks that have established offices in Malta mainly for tax purposes. The last offshore bank, Erste Bank, plans to become an onshore international bank in 2003.

70. **Government involvement in the banking system has been significantly curtailed.** The 70 percent government stake in Mid-Med Bank was sold in 1999 to HSBC, and its stake in Bank of Valletta reduced to 25 percent.

71. **The level of financial intermediation in Malta is high by EU accession country standards.** M2 exceeds 150 percent of GDP and credit extended to the private sector is more than 90 percent of GDP. To a very large extent, this results from the many years of stability in the banking system. In addition, Maltese residents have historically held significant amount of funds offshore. Some of this offshore money was repatriated to Malta in 2002 in response to several factors, notably: a temporary tax amnesty program; wider spreads between Maltese and European interest rates; and weaker international equity markets. Overall, the banking system contributes about 6 percent of GDP, and employs about 2.5 percent of the labor force.

### **Offshore and international financial services**

72. **Malta's separate offshore supervisory regime is now close to elimination.** Malta marketed its offshore regime between 1988 and 1994, with offshore businesses then given until September 2004 at the latest to either convert to the domestic regulatory standard or cease operations. Only one bank remains under the offshore regime and will soon convert. The authorities continue to encourage the conduct from Malta of international financial services business to which they will apply regulatory requirements equivalent to those applied in the domestic market. Among banks holding licenses in Malta, as noted, a number choose to specialize in business with nonresidents. Although classified as international banks, this reflects an administrative categorization rather than any legal distinction in their licensing. The mission recommends that additional supervisory attention be given by the MFSA to banks conducting international business while noting that they are small and limited in the range of activity. This may necessitate some increase in the frequency of on-site inspection work. With regard to consolidated supervision of international banks, the MFSA seeks to maintain close contact with the relevant home country regulators (particularly in Austria and Turkey).

73. **Malta is also in the course of eliminating offshore nominee companies.** Of the 2,600 such companies on the register (from a total number of companies registered in Malta of approximately 30,000), less than 300 remain. The last of these must cease operations by September 2004. Nominee companies are used mainly to shield their beneficial owners from being publicly identified, for tax and other reasons. Under Maltese legislation, the providers of this nominee registration service are regulated and subject to AML/CFT provisions. While these structures do not have direct implications for financial stability, abuse of the anonymity involved could cause reputational damage to Malta. The authorities are currently considering a proposal to terminate the overall nominee structure, not just the element that operated under the offshore regime. In its place, an expanded trust structure would be introduced, the legislation for which is in final draft and has been seen by the mission. A high level of anonymity would remain, being inherent in trust arrangements. The draft legislation includes provisions dealing with access to identification information in respect of all parties to the

trusts for the regulatory and tax authorities and for regulated institutions providing the trusts with financial services.

### **The nonbank financial sector**

74. **The nonbank financial sector is very small in asset terms, but contributes about 3 percent of GDP.** Twenty-one insurers (all onshore) operate in Malta but the sector is highly concentrated on only two of them. Total assets equal to about 15 percent of GDP. The insurance sector is growing strongly. Total assets nearly doubled over the past four years with life insurance business providing the main impetus for growth. Nevertheless, penetration and density ratios are still low compared to EU member countries. There are no private pension schemes, mortgage institutions, credit unions/cooperatives, or microfinance institutions.

### **B. Markets**

75. **The Maltese domestic capital market is small, the number of available investment vehicles is limited, and the secondary market is currently very thin** (Table 4). The mission recommended some improvements in the infrastructure, but a major development of the market could be envisaged through the integration with the EU market. The Malta Stock Exchange commenced operation in 1992. Share prices rose in tandem with the global demand for equities until 2000, and since then have fallen in line with international developments. Corporate bond issuance has been low, but picked up in 2002.

76. **The CBM actively quotes bid and offer prices for government securities in its role of market maker in the secondary market.** This was triggered by the lack of private market-making initiatives, and it was introduced to enhance investors' confidence. However, with virtually no government securities in its portfolio, the CBM has been able to operate only on the buy-side of the market. Government bonds, which are often held to maturity, have historically represented an important savings vehicle for Maltese residents in the absence of private pension schemes and in view of the one pillar Pay-as-You-Go system.

77. **Trading activity in the Maltese lira money market is very low due to the excess liquidity in the banking system and the small number of banks.** The money market consists of an unsecured cash market and a treasury bill market. Treasury bills, almost all of which are held by banks, are not dematerialized, and trading is on an unregulated over-the-counter basis. Due to the high excess liquidity in the banking system, currently very few interbank transactions occur—whether in treasury bills or in unsecured bank claims. Interbank interest rates, which are mostly in a one-week tenor, are very closely aligned with central bank rates, and are relatively stable, since all banks tend to be on the same side of the market. There are no interbank repo markets, nor other instruments such as commercial paper or certificates of deposit.

Table 4. Malta: Capital, Money, and Foreign Exchange Markets, 1998–2002

	1998	1999	2000	2001	2002
<b>Interbank money market</b>					
Turnover (Liri millions)	955	955	301	208	98
Turnover to GDP (in percent)	70.1	65.6	19.3	12.7	5.8
<b>T-bill market</b>					
Turnover (Liri millions)	344	287	74	154	124
Turnover to GDP (in percent)	25.3	19.7	4.7	9.4	7.4
<b>Government bonds</b>					
Turnover (Liri millions)	109	48	53	125	41
Turnover to GDP (in percent)	8.0	3.3	3.4	7.7	2.4
Turnover to capitalization (in percent)	17.2	6.8	8.1	15.4	5.0
<b>Equities</b>					
Market capitalization (Liri millions)	296	790	882	610	552
Market capitalization to GDP (in percent)	21.8	54.3	56.5	37.4	32.8
Turnover to market capitalization (in percent)	7.2	17.4	9.2	3.4	3.8
<b>Corporate bonds</b>					
Market capitalization (Liri millions)	27	41	106	108	159
Market capitalization to GDP (in percent)	1.9	2.8	6.8	6.6	9.4
Turnover to market capitalization (in percent)	5.8	5.1	4.2	13.9	6.5
<b>Foreign exchange</b>					
Turnover (Liri millions)	1,783	2,504	2,499	2,393	2,811
Turnover to GDP (in percent)	130.9	172.0	160.0	146.8	166.8

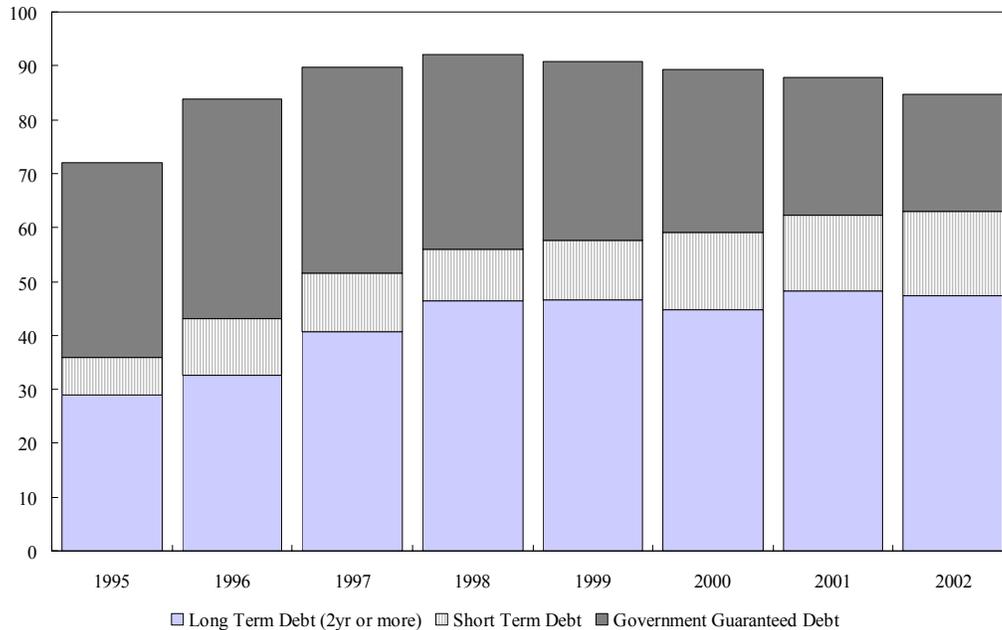
Sources: Central Bank of Malta, and Malta Stock Exchange.

78. **The most active financial market in Malta is the foreign exchange market with a turnover of over 167 percent of GDP in 2002.** However, this is low compared to other EU accession countries and also given the openness of the Maltese economy. The thinness of the market is largely due to strong seasonality, often resulting in banks being on the same side of the market, and because exporters and importers use foreign currency accounts to manage their foreign currency flows.

### C. Public Debt Management

79. **Malta's direct public debt stood at 64 percent of GDP in December 2002, while government-guaranteed debt amounted to an additional 22 percent** (see Figure). Most of the debt is denominated in Maltese liri, since Malta has not issued any foreign currency denominated securities. Some 75 percent of the direct debt consists of fixed-rate bonds with maturities ranging up to 20 years. The maturity profile of government securities is well-balanced and only 26 percent of bonds and treasury bills outstanding mature in one year or less. The stock of guarantees mainly consists of those provided by the government to domestic banks to cover loans granted to government agencies and state-owned enterprises. Banks hold most of the treasury bills (73 percent), while most bonds are held by nonbank financial institutions and the general public (52 percent).

Malta: Total Government Debt, 1995–2002  
(In percent of GDP)



#### D. Payment and Settlement Infrastructure

80. **In August 2002, the CBM introduced a sophisticated RTGS system (MaRIS), which handles large-value interbank and customer transactions and is operated and supervised by the CBM.** The amendments to the CBM Act have given to the CBM the legal powers for regulating and overseeing all payments systems in Malta. The four deposit money banks and the CBM participate in the system, which handles a daily average of 140 transactions for a value of Lm 50 million.

81. **The retail payments infrastructure in Malta remains relatively fragmented with traditional payment instruments, most notably checks, being widely used.** The only retail payment system is the CBM-operated Malta Clearing House, which is responsible for clearing checks and money orders. In contrast, the securities settlement system in Malta is highly integrated. The MSE provides for trading and clearing of securities. It also owns and operates the central securities depository. All securities in Malta, except treasury bills and collective investment schemes (CIS), are dematerialized.

#### E. Supervisory Framework

82. **Banking supervision has made substantial progress since the start of the bank regulatory process in 1970 when the first Banking Act was implemented.** The legislative

framework is in substantial compliance with EU directives and with international standards. The banking supervisors practice a method of risk-based supervision. Through the supervisors' knowledge of a particular institution (through on- and off-site supervision) and based on its risk profile, on-site examinations are conducted of specific risk areas, internal audit, and other areas. Staffing is adequate, and additional personnel have been added when needed. Staff are generally qualified, with much emphasis placed on training, participation in international best practice forums, and fluid communication with both the industry and international parties. The bank supervision department has built a platform from which it can continue to further evolve and enhance its practice.

83. **The process of building an insurance supervision framework was initiated in 1994.** The MFSA has introduced comprehensive prudential rules and regulations in 2000, and has inspected all insurance companies and intermediaries at least once since 2001. The MFSA also grants, refuses or revokes licenses, approves mergers, split and separation of insurers, and initiates bankruptcy proceedings.

84. **The regulation of the Maltese securities market has been transformed by the October 2002 amendments to the financial sector legislation.** These amendments aim to create a single competent regulatory authority for the entire capital market in the MFSA, with the MSE retaining a status of a Recognized Investment Exchange (RIE). All regulatory powers have accordingly been placed with the MFSA.

## OBSERVANCE OF FINANCIAL SYSTEM STANDARDS AND CODES: SUMMARY ASSESSMENTS

This section contains information on adherence to the key standards and codes relevant for the financial sector. The assessments have helped to identify the extent to which the regulatory and supervisory framework adequately addresses the potential risks in the financial system. It has also facilitated in identifying priority areas for recommendations for improved financial regulation and supervision.

Detailed assessments, except for the Criminal Law Enforcement, were undertaken under the supervision of Piero Ugolini (Mission Chief) as part of the Financial Sector Assessment Program by Laura Ard (World Bank) and Paolo Corradino (Banca d'Italia) for the *Basel Core Principles for Effective Banking Supervision*, Karsten Biloft (Danmarks Nationalbank) for the *CPSS Core Principles for Systemically Important Payment Systems* and *CPSS/IOSCO Recommendations for Securities Settlement Systems*, Luc Cardinal (World Bank) for the *IAIS Core Principles for Insurance Supervision*, Paula Perttunen and Elisabeth Sherwood (both World Bank) for the *IOSCO Objectives and Principles of Securities Regulation*, Terry Donovan and Peter Kyle for the methodology document prepared by the IMF and World Bank on *Anti-Money Laundering and Combating the Financing of Terrorism*, and Andrea Schaechter (IMF) and the other assessors for the *IMF's Code of Good Practices on Transparency in Monetary and Financial Policies*. The assessors prepared detailed assessments, drawing on information provided by the Maltese authorities, including self-assessments and field work during October 2002 and January 2003 missions. Giulio Sanarighi, Maggiore of the Italian Guardia di Finanza and Financial Action Task Force (FATF) expert, conducted an independent assessment of *Criminal Law Enforcement*.

Malta has achieved a high degree of observance of the international standards and codes that were assessed. Malta's legislation and regulatory framework has recently been revised to further comply with European Union Directives and international practices.

As regards banking supervision, assessors noted several areas for improvement. In particular, there is a need to strengthen the remedial action and enforcement aspect of supervision. Moreover, given the importance of real estate as collateral, the MFSA's process of assessing collateral values for purposes of asset classification and provisioning should be strengthened. The MFSA should enhance its emphasis on sound corporate governance and build on its technical analysis to draw more informed conclusions about the risk, performance, and board and management oversight and systems therein.

In the area of insurance supervision, further efforts are needed to improve the supervision of insurance company internal controls and investment policies, to formalize the MFSA's supervision of insurance company corporate governance procedures, to move to a more formal risk-based approach to supervision, and to establish formal arrangements for the exchange of information with all foreign insurers' home supervisors.

The oversight function for payment systems is still being implemented. Nevertheless, some weaknesses were identified, including a relatively long recovery time, a lack of a remote backup site, and a yet incomplete and untested contingency plan. For securities regulation, secondary legislation has only recently been completed for many areas and it was too early to assess the enforcement track record under the new regime. However, there is a need to clarify the legal framework for Central Securities Depository (CSD) and Clearing and Settlement of Securities (CSS) functions within the MSE.

Some recommendations were made to enhance transparency in monetary and financial policies, in particular, by disclosing more frequently the CBM's off-balance-sheet commitments. In the area of AML/CFT, the need to specifically criminalize financing of terrorism and provide additional resources and expertise was recommended.

## **BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION**

### **A. General**

85. The assessment of the effectiveness of Malta's banking supervision against the *Basel Core Principles for Effective Banking Supervision* was conducted as a part of the joint IMF-World Bank Financial Sector Assessment Program (FSAP). The assessment included a review of pertinent laws (Malta Financial Services Authorities Act, Malta Banking Act), banking directives, banking notices, and selected legal notices as well as supervisory checklists and other related documents. Moreover, the mission held meetings with the MFSA, banks, external auditors, the Bankers Association, and the Financial Police.

### **B. Institutional and Macprudential Setting, Market Structure—Overview**

86. The MFSA is headed by a Chairman and a seven member Board of Governors that sets policy for the authority. An Executive Coordination Committee exists to oversee the application of policies approved by the Board. The Supervisory Council is a committee composed of the director general and directors of each of the supervisory units (insurance, investment services, and banking) and the company compliance director. The role of this group is more operational and more directly influences banking supervision's ongoing activities. Its designated role is to license, monitor, and supervise all activities related to financial services. The Banking Supervision Unit has one director supported by three deputy directors and a total staff of 20.

87. The Maltese banking system consists of a domestic and an international component that operate independently of one another. The domestic component is highly concentrated and consists of four banks. Two of them (Bank of Valletta and HSBC Malta) are roughly the same size and clearly dominate the system, representing more than 90 percent of domestic system assets with similar shares of the deposit and loan markets for residents. The international sector consists of nine international banks and one offshore bank which deal with nonresidents in foreign currency and have mostly established offices in Malta for tax efficiency reasons. In 1996, registration of offshore activities ceased and the remaining activities will be completely phased out by 2004. The government has relatively limited involvement in the banking system. It has divested much of its ownership and now has a remaining holding (25 percent) in the large domestic bank, Bank of Valletta. The government's stake and that of Banco di Sicilia (15 percent) are for sale.

### **C. General Preconditions for Effective Banking Supervision**

88. The setting and circumstances in which the banking sector operates are generally satisfactory. The legislative framework for banking law and the powers provided to the MFSA to set implementing regulation are adequate although certain issues are cited in the assessment below. However, the legislative framework surrounding collateral and loan recovery requires strengthening. The foreclosure process can be lengthy and costly given the

inefficiencies in the legal system. This is particularly critical, since approximately 75 percent of the collateral held by banks is in the form of real estate.

89. The financial and enterprise sectors are required to use International Accounting Standards (IAS). Banks are audited according to international standards by recognized international auditing firms. The MFSA has full access to the auditors' reports and to the auditors themselves.

90. The supervisor has rarely resorted to severe forms of remedial actions or license revocation. Any problems experienced by banks in the past were resolved through market solutions. Even so, a broad framework for resolution of distressed banks is provided in the banking legislation. While these powers can be deployed as the supervisor deems necessary, there is a need to develop additional intermediate tools to help facilitate remedial supervisory action on a timely basis. A contingency plan exists to help coordinate authorities' action in the event of a crisis. An MoU was signed in February 2003 that provides for information sharing on an ongoing basis between regulatory bodies. A regulation approving the creation of a deposit insurance scheme came into force January 3, 2003. The scheme is being developed along the lines of EU standards.

#### **D. Main Findings**

91. The MFSA's compliance with the Basel Core Principles for Effective Banking Supervision is generally good. The progress of banking supervision has been commendable since the start of the regulatory process in 1970. Substantial effort has been made by the authorities to create a supervisory framework that is independent and effective. The supervisory effort is well supported by qualified and experienced staff who oversee the banking sector through comprehensive on and off-site processes.

92. The mission made several substantive recommendations in this review. It suggested that the supervisor should enhance its emphasis on sound corporate governance, both internally as concerns the MFSA and externally as it applies to bank boards and management. The identification and conclusions about risk levels, risk management, and board and management oversight can be enhanced. Also, the remedial action and enforcement aspect of supervision requires strengthening. Other recommendations for enhancing supervisory practice and oversight were also made in the context of the assessment.

#### **Objectives, autonomy, powers, and resources (CP 1)**

93. The MFSA, and therefore banking supervision, enjoys relative legislative and operational independence. By the design of the organization, the MoF is responsible for some key aspects of subsidiary legislation, penalties, and dispute process. While this has not compromised the operational independence of the MFSA, the MFSA should assume complete responsibility for all the relevant aspects of the supervision structure.

### **Bank licensing and structure (CPs 2–5)**

94. Banking legislation provides the MFSA with full powers to license banking institutions and reject license applications that do not meet the set standards. Legal Notice 155 provides authority to assess penalties for the misuse of the word “bank.” However, the magnitude of the penalty structure is considered minimal.

### **Prudential regulations and requirements (CPs 6–15)**

95. An adequate framework of prudential regulation and guidelines exists and addresses the wide range of financial risks in the banking system. Sufficient guidelines also exist for capital adequacy, credit policies, large exposures, market and other risks, internal control and audit, and anti-money laundering.

96. Several observations were made that could further enhance the area of risk assessment. The definition of related or connected parties contained in banking legislation is not all encompassing; it does not include executive management, significant shareholders, and auditors and related interests therein. The guidelines for credit risk management are generally adequate, but can be further strengthened. An updated regulation should further emphasize that banks properly reflect the fair value of their assets in financial reporting, through, in part, accurate classification of assets, accurate and timely loan loss provisioning, and well supported collateral valuation. Loan loss provisions are not tax deductible. Review of board governance and management oversight through evaluation of risk management processes, internal control adequacy, and audit processes should be further elevated.

### **Methods of ongoing supervision (CPs 16–20)**

97. The supervisors practice a method of risk-based supervision. Supervisory information is validated through off-site review of regulatory reporting and on-site evaluation of financial data as well as through the external audit process. The supervisor has the authority to conduct consolidated supervision, and communication with bank management is frequent. Areas that need further strengthening include the use of more formal examination procedures, regular communication with bank boards, frequency of on-site examinations, and the MFSA’s role in identifying and monitoring systemic risk in conjunction with the monitoring conducted by the CBM.

### **Information requirements (CP 21)**

98. The framework and legal structure for regulatory reporting, external audit, and financial statement disclosure is in place and functioning. The Banking Act requires that all information submitted to the supervisor be accurate and truthful. The verification process for information accuracy consists of the on-site examination process and external/internal audit. The use of enforcement provisions, including penalties for instances of making available inaccurate financial statements to the supervisor and the public, have not been frequently required. However, as such cases occur, the supervisor should establish and use tests of materiality as well as substance to determine what remedial actions should be taken.

**Formal powers of the supervisor (CP 22)**

99. The legal framework surrounding the enforcement powers of the supervisor is relatively broad. Available enforcement tools range from moral suasion, which has been the most frequent supervisory response, to relatively inconsequential penalties, the structure and magnitude, which is vetted by the Attorney General and signed off by the MoF, to license restriction. There seems to be no intermediate tool available between the lesser effect of monetary penalties and the more severe actions of restricting licenses. To date, the supervisor has relied primarily on ongoing communications with management, targeted on-site examinations, and supervisory follow up to address concerns. While the use of more severe remedial actions has not been necessary, the supervisor could expand and strengthen the use of corrective actions.

**Cross-border banking (CPs 23–25)**

100. The legal framework provides the authority to conduct cross border supervision and oversight. While domestic banks currently have no international operations, powers are in place to conduct consolidated supervision and for the exchange of supervisory information. The MFSA has the authority to enter into cooperative agreements with foreign supervisors, but it has not yet negotiated any MoUs.

**E. Recommended Actions and Authorities’ Response**

Table 5. Recommended Actions to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
Remedial Action and Enforcement	Develop an internal corrective action policy. Present reports of examination to bank boards; require they oversee the bank’s response to the supervisor. Recalculate provisions, earnings, and capital positions based on results of examinations; take corrective actions on that basis if warranted. Develop prompt corrective actions provisions that require the supervisor to take gradually increasing remedial action based on capital thresholds. Consider the use of formal written agreements or MoUs with banks in cases of significant and/or ongoing deficiencies or deteriorating trends.
Legal Framework for Banking Supervision	Enhance remedial action framework ; evaluate for fuller set of intermediate measures.
Loan Evaluation and Loan Loss Provisioning	Establish guidelines for collateral valuation; require banks to reflect well-supported valuations. Tighten guidelines for writing off assets. Include off-balance sheet assets in the classification and provisioning process. Include rigorous provisions for upgrading classified assets, placing credits back on an accruing status, and rebooking charged off assets.

Reference Principle	Recommended Action
Credit, Country, Market and Other Risks	Draw higher-level conclusions about overall risk levels, risk identification and management systems, and board and management oversight. Consider a supervisory directive that links the requirements of existing risk directives into a consolidated statement of the role of risk management and board and management responsibility therein. Prepare examination procedures for the analysis of various risks. Have supervisor or other independent body set required levels of loss provisioning related to country risk to ensure a level playing field in this area. Provide additional training in the area of market risk.
Internal Control and Audit	Further evaluate the adequacy of board governance through assessing their efforts to establish internal control and audit processes.
Accounting Standards	Take remedial actions based on the results of examinations, particularly in the case of identified, material financial misstatement of regulatory reports and/or published financial statements. Consider material misstatements of financial position violations of law.
Capital Adequacy	Recalculate loan loss provisions and capital adequacy based on examination results. Take supervisory action based on adjusted figures, as warranted.
On-Site and Off-Site Supervision	Develop further the use of an annual risk rating report that draws conclusions on all supervisory activities and risk analyses performed on a bank during the period. Develop supervisory strategies for each bank. Formulate procedures for both on- and off-site activities. Evaluate the frequency of on-site events. Ensure that the international banking sector receives an adequate allocation of supervisory attention to ensure risks therein do not go undetected. Enhance the MFSA's role in monitoring and drawing conclusions about systemic risk.
Money Laundering	Require banks to establish a policy statement on staff ethics and professional behavior. Introduce administrative penalties for banks failing to comply with MFSA money laundering guidelines.
Connected Lending	Implement the recently revised legislative definition of and restrictions on connected parties.
Objectives, Autonomy, Powers, and Resources	Establish "Rules of procedure" outlining Supervisory Council's oversight role and process. Establish signature authority for bank examination reports and other correspondence.
Operational Independence and Adequate Resources	Review penalty structure and amend it to create penalties that are meaningful.
Bank Management Contact	Conduct periodic meetings with bank boards to ensure communication and to reinforce their responsibilities and accountabilities.
Host Country Supervision	Include the existing banking directive into an explicit legal provision that prohibits banks or their affiliates from establishing operations in countries with secrecy laws or with regulations prohibiting flows of information necessary for adequate supervision.
Supervision Over Foreign Banks' Establishment	Continue efforts to negotiate and sign MoUs with the countries whose banking institutions have a presence in Malta. Devote additional supervisory attention to international banking group, as warranted.

### **Authorities' response**

101. The authorities took note of the Recommended Actions to improve compliance of banking supervision with the Basel Core Principles. Most of the actions recommended have already been implemented. Other actions will be implemented in line with the adoption of appropriate EU Directives and/or IASs, or following the approval of appropriate amendments to the legislation.

102. Regarding CP 10, the widening of the definition of connected parties is currently being discussed with the Bankers' Association, and it should be issued as a banking directive within the next three months.

103. As to CP 15 on Money Laundering, it is worth highlighting that all banks in Malta already have a code of ethics and professional behavior—while the Banking Act already provides for administrative penalties (Article 35) for non-compliance with guidance notes issued by an order of the competent authority.

104. For the most part, the authorities agree that the recommendations relating to on-site and off-site supervision would enhance present operating methodologies, which already meet the criteria established in the Basel Methodology document.

105. The legal framework for remedial measures is in place and timely corrective action has always been taken in the interest of depositors and the financial system. In fact, as acknowledged by the mission team itself, Malta has never experienced a banking crisis or a single bank failure. The authorities will, however, give due consideration to the recommendations of the mission team to further strengthen the process.

## **II. IAIS INSURANCE CORE PRINCIPLES**

### **A. General**

106. The assessment of the Maltese insurance sector supervision against the *International Association of Insurance Supervisors (IAIS) Core Principles* was performed as part of the Financial Sector Assessment Program. The information used includes (i) responses to a questionnaire and self-assessments prepared by the MFSA, (ii) laws, directives, and regulations, (iii) licensing and inspection procedures and checklists, and (iv) licensing files, off- and on-site reports, and correspondence. The mission held discussions with the MFSA, insurance sector participants, the Malta Insurance Association, external auditors, and the Association of Insurance Brokers.

### **B. Institutional and Macprudential Setting—Overview**

107. The insurance and reinsurance business activities and insurance managers in Malta are regulated by the Insurance Act of 1998 and the amendments, which came into force

October 1, 2002. The insurance intermediaries' activities are regulated by the Insurance Act and the Insurance Brokers and Other Intermediaries Act, 1998. The responsibilities and functions of the MFSA are set out in the Malta Financial Services Authority Act. The amendments to that Act entered into force on October 1, 2002. These laws are supplemented by many insurance directives and regulations to cover in more detail the technical aspects of insurance supervision.

108. The Maltese insurance sector consists of five local insurance companies, fourteen foreign insurance companies, and one affiliated insurer. A group of insurance syndicates from the U.K., Lloyd's, is classified separately as a Recognized Insurance Body. Thirteen of the insurance companies conduct only non-life insurance business, two concentrate on life insurance, and three offer both types of products. The only state-owned insurer conducts export credit insurance business. One "Insurance Manager," which administers a captive insurance company that writes insurance business exclusively for the benefit of its parent company, and four foreign "Mutual Associations" have also permits to conduct insurance business. Registration of offshore activities in Malta ceased in January 1997 and there are no offshore insurance companies remaining.

109. The insurance sector is small and highly concentrated, but growing strongly. Total assets stood at 15 percent to GDP at end-2001; nearly double that of 1997, with the life insurance business providing the main impetus for growth. Nevertheless, the penetration and density ratios are still low compared to EU member countries. At end-2001, the penetration ratio, expressed in terms of gross premium as a percentage of GDP, was 4.6 percent (compared to 17 percent in Italy), the density ratio, measured as market premium income per capita, was US\$100 (compared to US\$1,085 in Italy). The two largest local life insurance companies receive approximately 90 percent of the gross premiums, while the two largest non-life insurers receive nearly 45 percent.

### **C. General Preconditions for Effective Insurance Supervision**

110. To supplement the Insurance Act and the Intermediaries Act from 1998, the MFSA issued Insurance Directives and Insurance Intermediaries Directives in 1999. These are regularly revised to ensure their effectiveness and relevance to changing supervisory practices. In 2000, a number of important prudential rules were issued relating to, for example, solvency margins, assets valuation, determination of liability rules, and equalization reserves. Moreover, the insurance legislation was updated in 2002 to bring it in line with Malta's international commitments and to align it with amendments being introduced in other financial services legislation.

### **D. Main Findings**

111. While the MFSA observes most IAIS Core Principles, further efforts are needed to strengthen some areas. The supervision of insurance company internal controls and investment policies need to be improved. Moreover, the MFSA's supervision of insurance

company corporate governance procedures should be strengthened and moved to a more formal risk-based approach to supervision.

### **Organization of insurance supervisor (CP 1)**

112. The MFSA is responsible for administering insurance legislation and for granting, refusing or revoking licenses, approving mergers, split and separation of insurers, and initiating bankruptcy proceedings. It also performs the ongoing supervision of insurers and reinsurers, and intermediaries, including brokers, agents and sub-agents. The MFSA aims to ensure that persons authorized to conduct the business of insurance or insurance intermediary activities in or from Malta comply with the legislative provisions, regulations, and directives. The Insurance Business Unit of the MFSA currently comprises 12 staff, which appears to be sufficient to effectively carry out insurance supervision. MFSA staff members meet high professional standards and are protected against legal prosecution for actions taken as part of their duties by legislation.

### **Licensing and changes in controls (CPs 2–3)**

113. The MFSA licenses companies conducting insurance business in or from Malta. Insurers are required to have a sufficient number of directors and managers who satisfy the fit and proper criteria. Insurers must have adequate accounting and other records and systems of control in place to enable the company to be prudently managed and comply with the obligations arising out of the insurance legislation. The Insurance Act includes detailed provisions concerning changes in the ownership and disposal of a qualifying shareholding. The MFSA may turn down the change in an acquisition or disposal of such holding, but it must give its reasons for denial.

### **Corporate governance and internal controls (CPs 4–5)**

114. The MFSA's role in supervising internal controls of insurance companies needs to be strengthened. The MFSA places great emphasis on corporate governance but a guideline or directive in that area is lacking. During on-site inspections, the MFSA scrutinizes in great detail board minutes and investment committee minutes.

### **Prudential rules (CPs 6–10)**

115. Legislation and regulations set out some asset management standards for insurers. These need to be extended, in particular with regard to investment risk management policies and systems, and more effectively supervised. The minimum solvency margins do not yet fully depend on the size, complexity, and the business risks of the insurance company. This has not been an issue in Malta due to only one insurance group operating in Malta and the smallness and simplicity of the Maltese insurance market.

116. Local insurance companies only make sporadic use of derivative and off-balance sheet instruments. Nevertheless, the MFSA should introduce requirements to establish

adequate risk management and internal controls for derivative positions, and review them regularly as part of the on-site and off-site supervisory exercise.

### **Market conduct (CP 11)**

117. The MFSA has an extensive inspection program on market conduct. Furthermore, the MFSA has a very well organized separate business unit that deals uniquely with complaints.

### **Monitoring, inspections, and sanctions (CPs 12–14)**

118. The MFSA is currently revising the financial reporting systems for off-site supervision. Insurance companies are required to submit their audited financial statements to the MFSA not later than six months following the end of the financial year. Many license holders are also required to submit detailed monthly or quarterly management accounts. The data are, however, not yet stored in a database that could complement the on-site inspection system.

119. The MFSA intends to conduct visits to all license holders on an annual basis and has visited all insurance companies and intermediaries at least once since the beginning of 2001. On-site visits are usually conducted on a priority basis depending upon the perceived risk areas. The MFSA has the power to take remedial actions where problems involving licensed companies are identified.

### **Cross-border operations, supervisory coordination and cooperation, and confidentiality (CPs 15-17)**

120. The MFSA cooperates closely with most foreign supervisors. In the case of foreign insurers and reinsurers coming from jurisdictions with a supervisory regime acceptable internationally, the MFSA relies largely on the supervision carried out by the home supervisor. Even though the MFSA exchanges information with foreign insurers' home supervisors, the information exchange is not formalized and the frequency and scope varies across countries.

121. The MFSA deals with all documents and other information in its possession or under its control, or otherwise coming to its notice, concerning authorized companies and enrolled persons, as secret and confidential. These obligations extend to the members of the Board of Governors and the Supervisory Council and to all officers and staff of the MFSA. Moreover, the MFSA, its officials, and its agents are bound by the provisions of the Professional Secrecy Act.

## **E. Recommended Actions and Authorities' Response**

122. The mission's recommendations to further strengthen insurance supervision in line with the IAIS Core Principles are listed in Table 6. The MFSA has been very receptive to the

mission’s recommendations and has already undertaken a number of measures to further strengthen insurance supervision.

123. The MFSA indicated that it will establish corporate governance rules for all financial services license holders, including insurance license holders. Moreover, the MFSA is committed to ensure that insurers have appropriate internal controls in place. Steps have already been taken to amend the on-site inspection program to assess systems of internal controls, which insurers have in place. Inspection reports will include summaries of the conclusions of the review of these controls.

124. Investment practices and policies of insurance companies will be summarized in on-site reports. Moreover, the MFSA will review the investment policy guidelines even though it points out that insurers in Malta do not trade in derivatives and the Insurance Business (Company Assets and Liabilities) Regulations, 2000 already contain detailed valuation rules.

125. The MFSA is in the process of finalizing the revision of the detailed business forms complementing the financial reporting statements, which form part of the off-site reporting system. The MFSA pointed out that it already adopts a risk-based on-site compliance system; however, it will study what steps are necessary to further improve on-site inspection programs in this regard. Steps have already been taken to allocate more resources for on-site inspections by employing a new inspector and dedicating more resources of the insurance unit for on-site inspections.

Table 6. Recommended Action Plan to Improve Observance of IAIS Insurance Core Principles

Reference Principle	Recommended Action
Corporate Governance and Internal Controls	<p>Ensure that insurers have internal controls in place, which are of a nature and scope appropriate to the type and scale of their business.</p> <p>Issue more detailed guidance to the insurance companies and groups on how internal controls should be arranged and implemented.</p> <p>Require insurers to have an ongoing internal audit function of a nature and scope appropriate to the type and scale of the business. Ensure that the internal audit function has unfettered access to all the business lines and support departments, is independent, has sufficient resources and staff, and employs a risk-based methodology.</p> <p>Amend the on-site inspection program to state more precisely the work that has to be done by inspectors/supervisors with regard to the review of internal controls. Include summaries of the conclusions in the inspection reports.</p>
Prudential Rules	<p>Require insurers to put in place comprehensive investment risk management policies and systems for derivatives.</p> <p>Ascertain the effectiveness of on-site inspection of assets and their valuation through formalizing the inspection procedures and their documentation.</p> <p>Revise minimum solvency margins to depend more fully on the size, complexity, and the business risks of the insurance company.</p>

Reference Principle	Recommended Action
Monitoring, Inspection, and Sanctions	Finalize the revision of the detailed business forms complementing the financial reporting statements, which form part of the off-site reporting system. Move to risk-based on-site inspections.
Cross-Border Operations, Supervisory Coordination and Cooperation, and Confidentiality	Widen the exchange of information agreements with all home supervisors of foreign insurers, and regularly exchange information. In case of Malta's EU accession, separate agreements with EU countries are not needed, but focus instead on signing MOUs with those non-EU foreign counterparties where the cross-border exposure is most significant. Develop instruments to assess and ensure the solvency of foreign insurance companies.

## II. The CPSS Core Principles

### A. General

126. The assessment of the Malta Real-Time Interbank Settlement System (MaRIS) against the *Core Principles for Systemically Important Payment Systems (CPSIPS)* was done as part of the Financial Sector Assessment Program. The information used includes a self-assessment of MaRIS against the CPSIPS and the four central bank responsibilities, relevant legislation, rules and procedures, and other public information. Moreover, the mission met with the CBM, the MSE, the Malta Bankers Association, and two private banks.

### B. Institutional and Market Structure

127. In August 2002, the CBM introduced a sophisticated RTGS system (MaRIS) that handles large-value interbank and customer transactions and is operated and supervised by the CBM. MaRIS is the only system in Malta deemed to be systemically important. While the amendments to the CBM Act have given the CBM the legal powers for regulating and overseeing all payment system in Malta, operational procedures and directives are still being developed and drafted. The four deposit money banks and the CBM participate in the system, which handles a daily average 140 transactions for a value of Lm 50 million. MaRIS is a SWIFT-based system with fully automated transactions processing and a queuing facility that collects payment instructions waiting availability of funds and allows participants to send payments to the system outside the opening hours. In accordance with the CBM Act, the CBM may provide intra-day credit against adequate security to banks and financial institutions in Malta. Normally, MaRIS is open for transactions from 8:00 a.m. until 2:30 p.m. However, for customer payments, the closing time is 1:30 p.m. Participation in the system requires the fulfillment of a number of criteria, including notably membership in SWIFT and a settlement account at the CBM. The CBM is responsible for activating contingency procedures, including extension of the closing hour. A formal set of procedures is being negotiated with the participants.

128. The retail payments infrastructure in Malta remains relatively fragmented with traditional payment instruments, most notably checks, being widely used. The only retail payment system is the CBM-operated Malta Clearing House, which is responsible for

clearing checks and money orders. The Malta Clearing House is based on an interbank agreement for encashment, exchange, and clearing of checks between the participants.

### **C. Main Findings**

129. The MaRIS system exhibits no major weaknesses and most of the CPSS core principles are observed. However, since the system only started operations in August 2002, operational procedures and directives are still being developed and it is too early to fully assess the implementation of certain practices. Nevertheless, three areas for improvement were identified. The recovery time is relatively long—at least four hours—in case of a system breakdown and at the moment there is no remote back-up site. The CBM should also aim to complete the draft contingency plan and test it, and, lastly, it should publicly disclose the access criteria for participants to MaRIS.

130. The assessment against the CBM Responsibilities is also positive. Full observance with all Central Bank Responsibilities has not yet been achieved, since the establishment of an oversight function, including formulation of policies and their disclosure, has not yet been completed, but preparations are well under way. Policies and responsibilities are not publicly disclosed, except for the enabling legislation and legislation on consumer protection and prevention of money laundering.

#### **Legal foundation (CP I)**

131. The payment system has a sound legal basis. The amended CBM Act of October 2002 gives the CBM legal powers to offer and oversee payment system services, and issue directives regarding payment systems and operations. Three core directives, which are based on EU Directives, were issued in November 2002.

#### **Understanding and management of risks (CPs II–III)**

132. The system has clearly defined procedures for the management of credit and liquidity risk, the respective responsibilities of the operator and the participants are specified and well understood. There are incentives to manage and contain those risks. The MaRIS Operating Rules is the key document, which is signed by all participants and specifies the respective responsibilities of the operator and the participants and the general rules and procedures. Although the operating rules refer to the extension of the business day under abnormal circumstances, there is no clear reference to the decision and notification procedures in such circumstances. However, a draft contingency plan is currently being discussed. The MaRIS Operating Rules do not have procedures regarding the pledging of the collateral on the settlement accounts held with the CBM. Consequently, such procedures fall within those established by the CBM.

### **Settlement (CPs IV–VI)**

133. MaRIS provides prompt final settlement. Transactions must be settled through the settlement account with the CBM. A settlement is deemed final when the participant's account is credited on same day of value. A payment instruction is deemed to be unconditional and irrevocable at the moment when the sending participant's account is debited in the CBM Settlement Accounting System. A payment instruction may only be cancelled by the sending participant or by the CBM at the request of that participant provided its account has not been debited. Under exceptional circumstances that require individual justification, the operating rules allow for an extension of the business day under contingency arrangements. The policy and the manner in which such instances arise are detailed in a draft contingency plan for MaRIS.

### **Security and operational reliability, and contingency arrangements (CP VII)**

134. In general the system ensures a high degree of security and operational reliability; however there are three areas for improvement. First, the recovery time is relatively long at a minimum of 4 hours for the primary computer based system. Meantime, the participants' system recovery could well spill over to the next day. Second, there is no remote back-up site. And third, contingency plans are still in draft form and have not yet been tested.

### **Efficiency and practicality of the system (CP VIII)**

135. MaRIS appears to be cost efficient and practical for its users. Annual membership fees and transactions fees should cover the operational costs. The fees are based on estimated costs for the next five years and are adjustable annually. Any additional costs incurred by the participants to run the system have not been taken into consideration, since the participants will readily pass these charges on to the customer. Currently, the day-to-day volume is very low compared to the capacity of the system, which should be able to handle at least 15 transactions in one minute.

### **Criteria for participation (CP IX)**

136. Membership for banks is automatic when they have a settlement account with the CBM and are a SWIFT member. For financial institutions, membership would depend on the CBM's decision to establish settlement accounts for them. While there are directives that address minimum capital requirements for credit and financial institutions, there are no provisions for capital ratios for other potential participants. Moreover, risk rating, minimum payment volumes, or other quantifiable criteria are not utilized for considering access to participants. The present access rules could be publicly disclosed. There are no detailed exit rules.

**Governance of the payment system (CP X)**

137. Although MaRIS is fairly new, it appears that the system’s governance arrangements are effective, accountable, and transparent. Certainly, the main elements are in place. The MaRIS Operating Rules refer to the annual publication of accounts and the various responsibilities. Strategic objectives and plans, reporting lines, control, oversight and risk management responsibilities are still being formulated. While different offices within the CBM carry out audit and risk management functions, the operator and oversight responsibilities are still being established. At least once a year, financial accounts of the system will be approved by the Association of Participants, which is made up of representatives of the participants and a CBM representative, and distributed to all participants of the system. The annual financial report and a periodical overview are planned to be published. The CBM’s *Annual Report* also includes a section on the payment systems operations. A self-assessment will be carried out every two years in order to assess compliance with the core principles and consequently take any necessary action.

**Central bank responsibilities in applying the CPs**

138. The CBM is still in the process of formulating and organizing its role and policy objectives with respect to payment systems. Policies and responsibilities are not publicly disclosed, except for the enabling legislation and legislation on consumer protection and prevention of money laundering. The CBM has undertaken a first self-assessment of compliance with the core principles in respect of MaRIS. Subsequent to this, an appropriate work plan is to be developed and initiated. There is an understanding that the policy of analyzing compliance with the core principles is carried out at least once every two years. The CBM participates in a number of fora, both locally and abroad, including IMF, World Bank, Bank for International Settlements, the European Central Bank, the Malta Bankers’ Association, and meetings with the Malta Stock Exchange.

**D. Recommended Actions and Authorities’ Responses**

139. The recommended actions are listed in Table 7. The CBM acknowledges the importance of establishing a payment system oversight function and is committed to complete the process swiftly. It has already started and intends to take further steps, as suggested by the mission, to improve further the observance of CPSS Core Principles.

Table 7. Recommended Actions to Improve Observance of CPSS Core Principles and Central Bank’s Responsibilities in Applying the CPs

Reference principle	Recommended action
Security and operational reliability, and contingency arrangements	Reduce the recovery time from currently minimum four hours. Consider the possibility of creating a distant backup site. Finalize and test contingency plans.
Understanding and management of risks	Complete the contingency plan.

	Consider the information needs of potential new participants.
Criteria for participation	Formulate explicitly the participation rules for financial institutions and eventually other participants. Disclose publicly access and exit rules.
Governance of the payment system	Implement the drawn-up governance arrangements for the new MaRIS as planned.
Efficiency and practicality of the system	Make the pricing policy publicly available, such as on the CBM web site.
Responsibilities: Central Bank Responsibilities in applying the CPs	Address oversight and supervision in a Memorandum of Understanding between the CBM and the MFSA. Define and publicly disclose role and policy regarding oversight.

#### IV. IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

##### A. General

140. The assessment on Malta’s observance of the *IOSCO Objectives and Principles of Securities Regulation* was conducted as part of the Financial Sector Assessment Program. The assessment was based on (i) a review of the legal and regulatory framework; (ii) responses to the IOSCO questionnaire and methodologies; (iii) a self-assessment conducted by the MFSA and the MSE; (iv) discussions with the MFSA, the MSE, market participants, and industry associations; (v) information provided on the MFSA and MSE websites; and used the World Bank/IMF Staff Guidance Note for Assessment of IOSCO Principles.

141. The Maltese regulatory framework has been currently undergoing a period of fundamental change and transition, which makes it difficult to assess regulatory and supervisory practices or track record from the conduct of such responsibilities.

##### B. Institutional and Macprudential Setting, Market Structure

142. The issuance of the Financial Market Act, which became effective in October 2002, has removed all regulatory functions from the MSE, changing its status to a Recognized Investment Exchange (RIE) that is licensed, regulated, and supervised by the MFSA. Hence, the MFSA has assumed regulatory authority for stockbrokers, RIEs, listed entities, and market conduct. Moreover, the new legislation seeks to incorporate and reflect the following principal objectives: (i) to remove exclusivity of the MSE as the marketplace for trading of securities in Malta; (ii) to rationalize licensing, investigation, and sanctioning; (iii) to merge the jurisdictions of the MSE Tribunal and the Financial Services Tribunal; and (iv) to provide a clearly defined right of appeal to an independent and impartial tribunal. The relevant regulations as regards listing authorizations, related processes, and actual listings by the RIEs are presently being drafted by the MFSA.

143. The Maltese domestic capital market consists of local equities and corporate and government bonds, all of which are listed and traded on the MSE that was established in 1992. Market capitalization of outstanding securities at June 2002 totaled Lm 1,565 million (92 percent of GDP), of which just over half was government bonds, followed by equities (13 equities; 39 percent of market capitalization), and corporate bonds (16 corporate bonds; 7 percent of market capitalization). There are no securitized instruments or derivative products traded on the market. The MSE lists collective investment schemes, but these are not traded on the exchange. The domestic market is small and turnover is very low. The development of the equity market has been slow, reflecting the slow pace of privatization and the reportedly pervasive tradition of family control in the enterprise sector. However, tax benefits are provided to encourage equity listings by corporations on the MSE. Market intermediaries in the local capital markets consist of 19 stockbrokers and stock brokerage houses. MSE by-laws prohibit trading on their own account; consequently, there are no dealers or market makers on the MSE.

144. The mutual fund business in Malta is made up of 57 locally based schemes and 300 foreign-based schemes. Of the 50 CISs with a primary listing on the MSE, about two-thirds are managed by a fund manager directly associated with a bank. Fourteen are denominated in Maltese lira, although several of those invest outside of Malta as well. Locally managed CISs control approximately 10 percent of the total market capitalization of the MSE. The legal framework for the licensing of CISs was established in 1994 under the Investment Services Act. Between 1998 and 2002 there was an increase in CISs with a primary listing on the MSE from 12 to 50, and an increase in the net asset value of such schemes from Lm 138 million to Lm 218 million. The latter figure represents, however, a sharp decline from the end-2000 figure of Lm 331 million.

### **C. General Preconditions for Effective Securities Regulation**

145. The Maltese market regulations are in the process of being fully adapted to the EU Directives as part of the proposed EU accession process. The adopted regulatory policy will potentially have a positive developmental impact on the structure and the sophistication of the Maltese securities market. To a large extent, Maltese regulations have adopted European standards and, consequently, barriers to entry and exit have been largely abolished. For the provision of central securities depository (CSD) and central securities settlement (CSS) functions, however, there is a need to clarify any entry barriers.

### **D. Main Findings**

146. Observance of *IOSCO Objectives and Principles for Securities Regulation* is good. However, as the secondary legislation has only recently been completed to reflect the legislative reform of October 2002, it is too early to assess the enforcement track record under the new regime.

### **Regulator (Principles 1–5)**

147. The MFSA's responsibilities and objectives as the sole regulator and supervisor of the provision of financial services are clearly stated in the MFSA Act. The MFSA is an operationally independent body with its organization and the appointment and removal process of the members of the Board of Governors clearly stipulated in legislation. Serious uncertainties surround the regulation and supervision of the CSD and CSS functions and the related institutional arrangements are unclear, including the role of the CBM. This represents a significant weakness for ensuring smooth and credible operations of these functions.

### **Self-regulatory organizations (Principles 6–7)**

148. There are no functioning or stipulated self-regulatory organizations in the Maltese capital market.

### **Enforcement (Principles 8–10)**

149. The MFSA has comprehensive inspection, investigation, and enforcement powers. The MFSA may adopt a number of administrative and other measures against license holders found to have breached relevant regulatory requirements. The provisions are complemented by comprehensive investigation and inspection powers afforded to the regulator. Remedial action by license holders is required within set time frames to rectify breaches of license conditions, including breaches of financial resources requirements.

150. The MFSA conducts both on-site and off-site monitoring and compliance testing. Off-site supervision is carried out primarily through the analysis of financial returns and reports submitted by license holders and third parties, e.g., external/internal auditors, and ad-hoc meetings. Compliance visits assist the MFSA in monitoring how closely license holders adhere to license conditions and to the standards required by law. An on-going compliance-testing program is in place. No procedures have yet been established regarding surveillance, enforcement, and compliance of RIE's and their operations under the Financial Markets Act.

### **Cooperation (Principles 11–13)**

The amended financial sector legislation facilitates the exchange of information with both foreign and local authorities with regulatory, judicial or licensing functions. The powers vested with the MFSA enable it to assist foreign authorities in pursuance of serious regulatory concerns or detection, prevention, or prosecution of criminal offences. As part of its due diligence work, the MFSA contacts its foreign counterparts when required to obtain information regarding applicants for licenses or, for example, proposed directors or senior managers, which are or have been regulated overseas. The MFSA is in the process of expanding the range of its MoUs or similar agreements with foreign regulators which will further facilitate timely two way communication.

### **Issuers (Principles 14–16)**

151. Listed companies are obliged to provide the Exchange (for release to members) with any relevant information that would be “likely to materially affect the price of its securities.” Listing requirements and semi-annual reports, in line with IAS standards, enable investors to assess the financial and operational performance. The six months lag allowed for issuance of audited annual accounts is long by international standards. Accepting exceptions to the semi-annual disclosure requirement should be reconsidered.

152. The Company Act provisions and the MSE by-laws provide a modern and comprehensive framework for minority protection and rules regarding disclosure to existing shareholders of changes in shareholding, other key corporate decisions, including offering and allocation of new shares to existing shareholders. In addition, the by-laws require disclosure of shareholding above a five percent interest, and prohibit trading of shares by directors and others with non-public relevant information in some instances.

### **Collective investment schemes (Principles 17–20)**

153. Legislation and regulation for Collective Investment Schemes is well developed, including terms of entry, legal form and structure of CIS, segregation and protection of client assets, disclosure requirements, and asset valuation and pricing of units in CIS. There is scope for enhancement with regard to regulate potential conflicts of interest of fund operators (e.g., regarding the use of affiliated brokers or soft commissions) and explicitly define minimum “fit and proper” standards.

### **Market intermediaries (Principles 21–24)**

154. The standard license conditions set out in legislation and the Investment Services Guidelines provide the basis for the ongoing supervision of investment services license holders and licensed CISs. Investment services license holders are required to satisfy minimum financial resources requirements in respect of net tangible assets and liquid capital both prior licensing and post-licensing on an on-going basis. There are, however, no risk-related ongoing capital requirements. Another shortcoming is that guidance provided to license holders on risk management may not be sufficiently detailed.

155. There has been no failure of market intermediaries or license holders since the Investment Services Act was first enacted in 1994, and hence the relevant regulations and MFSA’s actual ability to act in protection of investors in case of such failure have not been tested. Nevertheless, the MFSA should establish more detailed principles and procedures for dealing with such failures.

### **Secondary market (Principles 25–30)**

156. The MSE is the only authorized exchange although the legislative amendments contemplate the possibility of having more than one exchange operating in/from Malta. Such

exchanges require approval from the MFSA. New regulations for RIEs under the Financial Markets Act have been issued beginning of 2003. Under the new legislation, the Recognized Investment Exchange (RIE) must report any suspicion of insider dealing or market abuse to the MFSA. In turn, the MFSA has the authority to appoint an inspector to carry out an investigation and report the results to the RIE when MFSA suspects inside dealing offense and market abuse. The MFSA also has an obligation to report any insider trading and market abuse to the Commissioner of the Police. Currently market surveillance continues to be undertaken by the MSE's Compliance Office. The way in which the MFSA's role as the competent authority will be implemented in practice is still under consideration.

157. While there is an established practice as regards the regulation and supervision of CIS and licensed investment services providers, the practices related to the supervision of RIEs, and related CSD and CSS functions, listed entities and market conduct are in the process of being established. Regardless, as the MFSA is an experienced securities regulator and has a good track record in its past areas of competence, it is expected that the widening of its supervisory responsibilities will be completed smoothly in a timely fashion.

158. The present operational arrangements for Central Securities Depository (CSD) and Clearing and Settlement of Securities (CSS) functions within the MSE appear to be largely appropriate for the nature and size of the domestic market today. However, the legal foundations for the institutional arrangements, for their regulation and supervision, and for the dematerialization itself do not appear sufficiently solid.

#### **E. Recommended Actions and Authorities' Response**

159. The mission's recommendations to strengthen securities regulation and come into full observance with the IOSCO Principles are listed in Table 8. The authorities are committed to complete the transition process of the regulatory regime and have already taken steps to address the mission's recommendations, including the following.

160. While there are plans to segregate the CSD from the MSE and to establish a clearer legal and regulatory framework for the CSD, the oversight of securities settlement is being discussed with the CBM. Moreover, the MoU between MFSA and CBM, signed on February 4, 2003, refers to the broad CBM's responsibility for the oversight of securities settlement. A more specific MoU is being finalized.

161. Regulations have been issued in January 2003 to define the standards to which the MSE must adhere as a Recognized Investment Exchange. In addition, notification directives were issued effective April 7, 2003. Financial resources and reporting rules for investment services license holders in line with the EU Capital Adequacy Directive have been drafted and are scheduled for adoption in 2004.

Table 8. Recommended Plan of Actions to Improve Observance of the IOSCO Objectives and Principles of Securities Regulation

Reference Principle	Recommended Action
Principles Relating to the Regulator	Clarify the regulation and supervision of the CSD and CSS functions and the related institutional arrangements. Spell out explicitly the MFSA’s and MSE’s applied procedures and required lines of reporting.
Principles for Cooperation in Regulation	Expand the range of the MFSA’s MoUs or similar agreements with foreign regulators to facilitate timely two way communication.
Principles for Issuers	Reconsider the exceptions to the half-yearly disclosure requirement. Reduce the six months lag allowed for issuance of audited annual accounts.
Principles for Collective Investment Schemes	No action required.
Principles for Market Intermediaries	Implement the EU Capital Adequacy Directive requirements. Review and consider the overall solvency arrangements of the market structure (including the MSE and its CSD and CSS functions). Issue guidelines as regards the CSD and CSS functions that put greater emphasis on risk management and the importance of business continuity. Establish more detailed principles and procedures for dealing with a market intermediary failure.
Principles for the Secondary Market (CP 25–30)	Finalize issuance of detailed directives for the RIEs under the Financial Markets Act. Issue specific legislation for the dematerialization of securities and the institutional infrastructure and the regulation and supervision of CSD and CSS functions.

## V. IMF CODE OF GOOD PRACTICES ON TRANSPARENCY IN MONETARY AND FINANCIAL POLICIES

### A. General

162. The following considers the transparency practices of monetary policy, payments systems oversight, banking supervision, insurance supervision, and securities regulation in Malta as it relates to the principles underlying the Fund’s *Code of Good Practices on Transparency in Monetary and Financial Policies*. The assessment was undertaken under the auspices of the IMF–World Bank Financial Sector Assessment Program.

### B. Information and Methodology Used for Assessment

163. The assessment was based on (i) relevant legislation and regulations; (ii) CBM, MFSA, and MSE documents and publications available on the authorities’ websites and provided to the mission; (iii) discussions with the CBM, MFSA, MSE, market participants, industry associations, and observers of monetary policy; (iv) the authorities’ responses to questionnaires; and (iv) self-assessments by the CBM for transparency practices in monetary

policy and by the CBM/MFSA on financial policies. The authorities were most helpful in their cooperation.

### **C. MFP Transparency Code—Monetary Policy**

#### **Institutional and market structure**

164. Amendments to the Central Bank of Malta (CBM) Act, which entered into force October 1, 2002, addressed some fundamental issues concerning monetary policy. The amendments made price stability the primary objective of the CBM, strengthened the legal and operational independence of the CBM, and explicitly prohibited central bank financing of public sector deficits.

165. The CBM uses a peg of the Maltese lira to a currency basket, consisting of the euro, pound sterling, and U.S. dollar, as its intermediate target. The exchange rate peg has contributed to moderate inflation in Malta. In addition to foreign exchange operations, the main domestic policy instrument is the weekly sale of 14-day CBM term deposits or repurchase agreements against government securities. With the amendments to the CBM Act, the Governor of the CBM, who is appointed by the President of Malta for a period of five years, is solely responsible for decisions on monetary policy. He is advised by the newly established Monetary Policy Advisory Council.

#### **Summary of main findings**

##### ***Clarity of roles, responsibilities and objectives of the CBM for monetary policy***

166. The CBM clearly defines its role, responsibilities, and objectives with regard to monetary policy. The monetary policy framework has been described and explained in many CBM publications and in public appearances by CBM officials. The procedures for appointment, terms of office, and general criteria for removal of the Governor, Deputy Governor, and the three other members of the Board of Directors are spelled out in the CBM Act. There are two areas in which the CBM could become more transparent: (i) defining and explaining more explicitly the objectives and operating procedures regarding the CBM's role in the market for government securities; and (ii) disclosing the terms and conditions for government deposits held with the CBM.

##### ***Open process for formulating and reporting monetary policy decisions***

167. The CBM formulates and reports its decisions on monetary policy mostly in an open way. Monetary policy decisions are publicly disclosed and explained immediately after they have been taken. Banks commended the CBM for including them at an early stage in preparing substantive technical changes. Further improvements can be made by providing more detailed explanations on the functioning and characteristics of monetary policy instruments, and announcing a publication calendar for the *Quarterly Review*.

***Public availability of information on monetary policy***

168. The CBM makes a wide range of information on monetary policy available to the public. The CBM’s publication program includes a weekly *Money Market Report*, the monthly *Monetary Statistical Release*, its *Quarterly Review*, and its *Annual Report*. These publications, in addition to the monthly CBM balance sheet, press releases, statistics, speeches, and the like, are regularly posted on the CBM’s website. The key weakness is the lack of frequent information on the CBM’s off-balance sheets items, in particular forward contracts.

***Accountability and assurances of integrity by the CBM***

169. The CBM uses a range of transparency practices regarding its accountability and assurance of integrity, but does not provide detailed information on its expenses and revenues and has made publicly available only a part of the staff code of conduct. As required by the CBM Act, the Governor appears regularly before parliament and a parliamentary committee to answer questions on the overall performance of the CBM, its monetary policy, its operations, and financial statements. In its *Annual Report*, the CBM publishes its detailed audited annual accounts based on the International Accounting Standards.

**Recommended actions and authorities’ response**

170. The mission recommends the actions listed in Table 9 to further improve transparency practices in monetary policy. The authorities were most receptive to the mission’s recommendations and are committed to swiftly implement many of them. In this context, some of the recommendations (such as the description and characteristics of monetary policy instruments and information on forward contracts) were implemented. However, the authorities also emphasized that releasing certain types of information could be misinterpreted by the public.

Table 9. Recommended Actions to Improve Observance of IMF’s MFP Transparency Code Practices—Monetary Policy

Reference Practice	Recommended Action
Clarity of Roles, Responsibilities and Objectives of Monetary Policy	Describe and explain the objectives and operating procedures of the CBM’s role in the market for government securities. Consider phasing out the CBM’s pricing role once a system of primary dealers has been implemented. Publish the terms and conditions for government deposits (including those of the Sinking Funds) held with the CBM.
Open Process for Formulating and Reporting Monetary Policy	Describe and explain in more detail the characteristics and functioning of monetary policy instruments. Announce a calendar for the publication of the <i>Quarterly Review</i> .
Public Availability of Information on Monetary Policy	Report on a monthly basis foreign currency off-balance sheet items of the CBM. Release the monthly balance sheet at a preannounced schedule.
Accountability and Assurances of Integrity by the CBM	Include a detailed income statement in the published annual financial statements of the CBM. Indicate on the website that the Staff Code of Rules and Regulations is available upon request.

## **D. MFP Transparency Code—Payment Systems Oversight**

### **Institutional and market structure**

171. The oversight function is still in the process of being established, but amendments to the CBM Act, which entered into force October 1, 2002, provided the CBM with the authority to oversee and regulate the payment systems. In August 2002, the CBM introduced a sophisticated RTGS system (MaRIS) which handles large-value interbank and customer transactions, and is operated and supervised by the CBM. The four deposit money banks and the CBM participate in the system, which handles an average daily 140 transactions with a value of Lm 50 million.

### **Summary of main findings**

172. The assessment of transparency practices for payment system oversight has to be seen against the backdrop that the oversight function is still in the process of being formulated and established within the CBM. Moreover, the oversight function is an integral part of the CBM. For that reason, many transparency practices follow from general CBM policies as they have been described in the section on transparency practices in monetary policy (see above).

### ***Clarity of roles, responsibilities and objectives of the CBM for payment system oversight***

173. While the amendments to the CBM Act have given the CBM the legal powers for regulating and overseeing all payment systems in Malta, the CBM has not yet fully explained and described to the public its objectives and role in payment system oversight. However, it has begun to post some information regarding the payment system on its web site and it routinely reports on payment system operations in its *Annual Report*. There is no clearly established relationship between the CBM and the MFSA with regard to payment systems oversight and securities settlement, except for the general MoU between both institutions, which, however, has not yet been publicly disclosed.

### ***Open process for formulating and reporting payment system oversight policies***

174. The role of the CBM in payment system oversight, including policy principles, reporting requirements, operating procedures, and confidentiality guidelines, has yet to be established, but the regulatory framework is in place. The CBM intends to make its operating procedures publicly available, and announce and explain changes in its policy. The CBM has already introduced a procedure for consulting with participants on technical and regulative changes regarding MaRIS. Existing directives have recently been posted on the CBM website.

### ***Public availability of information payment system oversight policies***

175. The CBM *Annual Report* contains a section on payment systems operations and the CBM posts some information about the payment system on its website. Moreover, the CBM

provides aggregate data to the ECB Blue Book on payment and securities settlement systems in accession countries. A more detailed account on MaRIS and the CBM’s oversight role is not yet available.

***Accountability and assurances of integrity by the CBM***

176. The CBM uses a range of transparency practices regarding its accountability and assurance of integrity, but does not provide detailed information on its expenses and revenues, including those for operating and overseeing MaRIS. As required by the CBM Act, the Governor appears regularly before parliament and a parliamentary committee to answer questions on the overall performance of the CBM, its operations, and financial statements. In its *Annual Report*, the CBM publishes its detailed audited annual accounts based on the International Accounting Standards.

**Recommended actions and authorities’ response**

177. The mission recommends the actions listed in Table 10 to further improve transparency practices in payment systems oversight. The authorities are committed to swiftly implement most of them once the oversight function becomes more firmly established.

Table 10. Recommended Actions to Improve Observance of IMF’s MFP Transparency Code Practices— Payment Systems Oversight

Reference Practice	Recommended Action
Clarity of Roles, Responsibilities and Objectives for Payment Systems Oversight	Complete the process of establishing a payment systems oversight function within the CBM. Formulate policies and objectives for oversight and convey these to the public.
Open Process for Formulating and Reporting on Payment Systems Oversight Policies	Discuss with participants and other interested parties the scope, aim, methods and reporting associated with payment systems oversight. Define the relationship between payment system oversight and securities settlement in an MoU between the CBM and the MFSA.
Public Availability of Information on Payment Systems Oversight	Provide a detailed account of oversight policies and operating procedures once these are established.
Accountability and Assurances of Integrity by the CBM	Disclose costs incurred in operating and overseeing the payment system. Consider assistance from the internal auditors in the payment systems oversight function.

**E. MFP Transparency Code—Banking Supervision, Insurance Supervision, and Securities Regulation**

**Institutional and market structure**

178. With the amended legislation entering into force in October 2002, the MFSA assumed responsibility for supervising and regulating the banking, in addition to the responsibilities it held for supervising and regulating the insurance, and securities sectors.

The revision of laws and directives have incorporated EU requirements and overall international best practices, but the regulation of the Maltese securities market is not yet completed since secondary legislation still needs to be implemented.

179. Malta's financial system is dominated by the banking sector, which accounts for 90 percent of financial sector assets. The insurance and securities sectors are very small. The domestic banking sector comprises four banks, which also have stakes in the insurance and securities sectors. Two large banks each hold about 45 percent of banking sector assets and the government has a 25 percent stake in one of the large banks. There is also an onshore international banking segment consisting of nine banks, but there are no significant links to the domestic financial system. The insurance sector comprises 21 insurers with total assets equal to about 15 percent of GDP. The sector is dominated by two insurers in particular in the life insurance segment. The Maltese domestic capital market is small (41 percent of market capitalization for equities and corporate bonds) and secondary market trading activity is currently very low.

### **Summary of main findings**

#### ***Clarity of roles, responsibilities and objectives of the MFSA***

180. The MFSA clearly defines its roles, responsibilities, and objectives for financial policies. The broad objectives are defined in legislation, and explained in MFSA seminars and public discussions. The responsibility for regulating and supervising the CSD and CSS is not yet formalized but under consideration.

#### ***Open process for formulating and reporting of financial policies***

181. The MFSA formulates and reports on its financial policies in an open manner. The regulatory framework and operating procedures are contained in legislation, directives, and notices which are publicly available. Proposed technical changes of financial regulations are discussed with the industry in the Financial Services Consultation Council. The only shortcoming lies in the lack of public information about information sharing arrangements between the MFSA and domestic and foreign agencies.

#### ***Public availability of information on financial policies***

182. The MFSA, MSE, and CBM make available a range of information on the developments in the financial sector and financial policies. The CBM continues to publish data and articles on developments in the banking sector. A six monthly financial stability article is planned to be published starting June 2003. The article will include comments on the banks' asset quality and publish the aggregate NPLs data for all the banks operating under the domestic banking license. The MFSA publishes information on the insurance sector and the MSE about the securities market. The MFSA also issues a monthly newsletter, maintains a public information service, and MFSA senior officials participate in seminars, conferences, and public meetings.

***Accountability and assurances of integrity by the MFSA***

183. The MFSA uses a number of transparency practices to ensure its accountability and integrity. The MFSA reports to parliament typically once a year and is required by law to submit to parliament its *Annual Report* and annual financial accounts. The financial statements are, however, not included in the *Annual Report* or posted on its website. Internal audit and control arrangements exist but are not yet explicitly drawn up. Legislation and staff rules are in place for the conduct of personal financial affairs and to prevent conflict of interest. While legislation is public, the rules in the MFSA Staff Handbook are not yet publicly disclosed.

**Recommended actions and authorities’ responses**

184. The recommended actions are listed in Table 11. The authorities were in broad agreement with the mission’s findings and recommendations and have indicated that they are committed to make swift progress to further improve good transparency practices.

Table 11. Recommended Plan of Actions to Improve Observance of IMF’s MFP Transparency Code Practices—Banking Supervision, Insurance Supervision, and Securities Regulation

Reference Practice	Recommended Action
Clarity of roles, responsibilities and objectives of payment system oversight agencies	Finalize and make publicly available an MoU that formalizes the roles and responsibilities in regulating and supervising the CSD and CSS. Make publicly available the recently signed MoU between the CBM and the MFSA agreeing on the agencies bilateral relationship.
Open process for formulating and reporting of payment system oversight policies	Make all MoUs publicly available. Announce the cases for information sharing with foreign agencies even if no MoU has been signed.
Public availability of information on payment system oversight policies	No action required.
Accountability and assurance of integrity by payment system oversight agencies	Draw up and disclose internal audit and controls arrangements and procedures for the MFSA. Consider making the financial statements of the MFSA and MSE an integral part of their annual reports.

**IV. ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM**

**A. Introduction**

185. This Report on the Observance of Standards and Codes for the *FATF 40 Recommendations for Anti-Money Laundering and 8 Special Recommendations Combating the Financing of Terrorism* was prepared by a team composed of staff of the International Monetary Fund and World Bank, and an expert not under the supervision of Fund and Bank staff selected from a roster of experts in the assessment of criminal law enforcement

measures.<sup>7</sup> The report provides a summary of the level of observance with the FATF 40+8 Recommendations, and provides recommendations to strengthen observance.

### **B. Information and Methodology Used for the Assessment**

186. In preparing the detailed assessment, Fund and Bank staff reviewed the relevant AML/CFT laws and regulations and supervisory and regulatory systems in place to deter money laundering and financing of terrorism among prudentially regulated financial institutions. The expert not under the supervision of Fund and Bank staff reviewed the capacity and implementation of criminal law enforcement systems. The assessment is based on the information available at the time it was completed on January 31, 2003.

### **C. Main Findings**

187. Malta has in place a sound and comprehensive legal, institutional, and policy framework for AML/CFT. Maltese law provides comprehensively for the prevention of money laundering (ML), but does so by means of a variety of laws and regulations. The main legislation is the Prevention of Money Laundering Act, which was enacted in 1994 and amended in 1998, 2001 and 2002. The Act is complemented by the Prevention of Money Laundering Regulations of 1994, which were also amended in 2000 and 2002 and represent well-drafted, binding, and enforceable secondary legislation. These provisions address the core elements of the FATF 40 + 8 Recommendations and of most of the methodology used to assess compliance therein. A number of further points of detail in the methodology are currently addressed in a series of Guidance Notes, which complement the legal and institutional framework. Malta has ratified the Vienna Convention, signed the Palermo Convention, ratified the Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds of Crime, and has fully or partially implemented UN Resolutions relating to the prevention and suppression of the financing of terrorist acts.

188. Malta criminalizes money laundering (ML) in a manner that is broadly consistent with international standards and imposes the requisite criminal, civil, and administrative sanctions for violations. However, financing of terrorism (FT) is not specifically criminalized although the authorities believe that existing legislation is adequate to deal with situations involving FT. The position should be placed beyond any doubt by the enactment of a specific criminal offense proscribing FT. The coverage of the list of predicate offenses for money laundering is broad and includes the crimes specified in the Vienna Convention. The offense of ML extends not only to those who have committed ML but also to those persons who have

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<sup>7</sup> The team consisted of Terry Donovan, IMF, and Peter Kyle, World Bank, with Giulio Sanarighi, Major, Guardia di Finanza, Italy, fulfilling the role of Independent AML/CFT Expert (IAE) to deal with law enforcement issues, which are not within the Fund/Bank assessment responsibility. Throughout this report, portions of the assessment attributable to the IAE are shown in italicized text.

committed both the laundering and the predicate offense. The law applies to any person whether the offense is attempted or consummated and adequately deals with accomplices and, in the case of a body of persons, the liability of individual officers as well as the corporate entity itself.

189. The authorities have wide investigative powers and a number of special procedural remedies, including investigation and attachment orders. After conviction, the authorities may obtain a freezing order and an order for forfeiture after judgment. Strong penalties are provided for failure to comply with these orders or to comply with other provisions of the Act or of the Regulations.

*190. Statistics are maintained on the levels of property seized and confiscated, of suspicious transaction reports (STRs) received, judicial orders obtained, investigations conducted and prosecutions brought. The number of STRs appears low. Both the quantity and quality of reporting is expected to benefit from the establishment of the Financial Intelligence Analysis Unit (FIAU). The FIAU needs to take steps to improve further the AML/CFT awareness and knowledge of the reporting institutions, particularly those institutions and sectors that may have been underreporting suspicious transactions in the past. The FIAU needs to provide systematic feedback to institutions on STRs received. There has been just one successful prosecution to date for ML offenses and this is subject to appeal. Relevant statistics are maintained on instances of cooperation sought from and provided to other jurisdictions.*

*191. Following the reorganization of the relevant police structures, including the creation of a Money Laundering Unit, and the establishment of the FIAU, a significant improvement in the effectiveness of investigations and law enforcement is anticipated. Every STR forwarded to the police is investigated in detail and investigation files can remain open for considerable periods of time. The establishment of the FIAU should provide the desired filtering and improve the effectiveness of the process. If there is an increase in the number and quality of STRs resulting from the work of the FIAU, it may be necessary to strengthen the existing police structure. The use of special investigative measures needs to be reexamined, with explicit introduction of all possible investigative measures on ML/FT in the work of the police.*

192. In terms of international cooperation, Malta has in place a number of laws and procedures that provide a wide range of mutual legal assistance in ML/FT matters. It is a party to the European Convention on Mutual Assistance in Criminal Matters and has signed twelve bilateral agreements with other countries within its geographical vicinity.

193. Provisions in relation to customer identification, record keeping and reporting of suspicious transactions are broadly in line with the international standard. However, in the case of nominees (and trustees, if proposed trustee legislation is enacted) customer identification requirements should be extended to require the independent application by regulated financial institutions of full customer identification procedures, as are applied to

customers generally. The provisions for professional intermediaries (lawyers, accountants, etc.) should also be reviewed and brought into line with the latest international standards.

194. With regard to implementation, the FIAU is now the competent authority for AML/CFT in Malta, having a statutory role under the PMLA to monitor compliance, and to liaise with the supervisory authorities, principally the MFSA, to ensure such compliance. Although its statutory responsibilities are clear, the FIAU is still building up its operational capability, and it is not yet evident how the respective roles of the FIAU and the supervisory authorities will combine in practice. The FIAU can appoint any or all of the supervisory authorities as its agent and can collect relevant data and information on AML/CFT policies and procedures either directly from regulated financial institutions or via the supervisory authorities. These supervisory authorities meanwhile continue to carry out their AML/CFT functions, using their powers under the sectoral Acts, in seeking to ensure that regulated entities comply with the requirements of the Prevention of Money Laundering Act (PMLA). In particular, the MFSA (formerly Malta Financial Services Centre), is now the single regulatory authority for banks, securities, insurance and bureaux de change, in addition to carrying out the role of Registrar of Companies. MFSA includes AML/CFT within the scope of its overall on- and off-site supervision work. Each of its sectoral supervision units devotes resources to AML/CFT work and some dedicated AML/CFT on-site examinations of regulated institutions are conducted. The level of resources and specialist expertise in the area of AML/CFT in the MFSA should be reviewed and increased as necessary to expand the program of on-site inspections to include, in particular, the international banks and a sample from the branch network of the domestic banks.

195. A Prevention of Money Laundering Joint Committee was formed, comprising representatives of the financial sector institutions and the authorities. The committee had not met for some time, due to structural changes outlined above but is due to meet again soon.

196. Discussions with a representative selection of industry representatives confirm a strong awareness of AML/CFT risks and legislative and supervisory requirements. Industry confirmed the active role of the MFSA and the emerging influence of the FIAU which was widely and warmly welcomed.

197. The Companies Registry in the MFSA is also within the domain of AML/CFT implementation. This is particularly relevant in the ongoing supervision of regulated nominees (likely to be superseded by a regulated trustee regime), who are responsible for AML/CFT due diligence in respect of the beneficial owners of registered companies with nominee shareholding. Brief on-site examinations of regulated nominees are conducted by MFSA and include an AML/CFT component.

#### **D. Summary Assessment Against the FATF Recommendations**

198. While Malta is in broad compliance with the FATF 40 + 8 Recommendations, there is room for further improvement and enhancement in certain areas covered by the

Recommendations and the Methodology used to assess observance therewith, as set out in Table 12.

Table 12. Recommended Action Plan to Improve Compliance with the FATF Recommendations

Reference FATF Recommendation	Recommended Action
40 Recommendations for AML	
General framework of the Recommendations (FATF 1–3)	-
Scope of the criminal offense of money laundering (FATF 4–6)	-
Provisional measures and confiscation (FATF 7)	-
General role of financial system in combating ML (FATF 8–9)	-
Customer identification and record-keeping rules (FATF 10–13)	<p>Address the following points.</p> <ul style="list-style-type: none"> <li>• Consider introducing an explicit provision requiring the renewal of identification should doubts appear regarding identity in the course of the business relationship.</li> <li>• Consider introducing in the law or regulations a requirement in relation to the inclusion of name, address and account number when transmitting funds.</li> <li>• Supplement the current Guidance Note by introducing a specific legislative requirement to include originator information on fund transfers.</li> <li>• Establish a requirement for graduated customer acceptance policies, and additional focus on high risk customers</li> </ul> <p>In relation to nominees (and trustees under the proposed new legislation), require financial institutions to verify the due diligence carried out by nominees/trustees, to help to minimize the reputational risk to Malta from the continuation of this category of business.</p> <p>With regard to dealings by financial institutions with other professional intermediaries (as specified in Regulation 7), acting on behalf of clients, require information on the identity of the beneficial owner/client to be made available to the financial institution, in line with, among other things, the interpretative note to FATF Recommendation 11, having due regard to the provisions of the Second EU AML Directive.</p>
Increased diligence of financial institutions (FATF 14-19)	<p>Introduce specific provisions dealing with complex and unusual transactions and high-risk accounts by the authorities in addition to the current measures.</p> <p>Establish an overall standard for the quality, coverage, and updating of AML/CFT policies and procedures documentation and check for implementation in the course of on-site inspections. Use FIAU powers in terms of collecting and reviewing such documentation in conjunction with the MFSA or otherwise.</p> <p>Criminalize negligent money laundering.</p>

Reference FATF Recommendation	Recommended Action
Measures to cope with countries with insufficient AML measures (FATF 20–21)	Introduce a specific additional requirement in relation to countries believed to have poor know-your-customer (KYC) standards, in addition to PMLR reference.
Other measures (FATF 22–25)	-
Implementation & role of regulatory and other administrative authorities (FATF 26–29)	<p>Increase the frequency of on-site ML/FT work, particularly for international banks as well as insurance and securities firms. Introduce a program of bank branch ML/FT inspections. To achieve this, expand specialist ML/FT resources currently available to the MFSA’s supervisory units.</p> <p>Reactivate the Prevention of Money Laundering Joint Committee as quickly as possible, with all relevant financial services industry segments represented.</p> <p>Complete and issue the draft consolidated Guidance Notes as quickly as possible.</p>
Administrative Cooperation – Exchange of general information (FATF 30–31)	-
Administrative Cooperation – Exchange of information relating to suspicious transactions (FATF 32)	-
Other forms of cooperation – Basis & means of cooperation in confiscation, mutual assistance, and extradition (FATF 33–35)	-
Other forms of cooperation – Focus of improved mutual assistance on money laundering issues (FATF 36–40)	-
8 Special recommendations on terrorist financing	
I. Ratification and implementation of UN Instruments	-
II. Criminalizing the financing of terrorism and associated money laundering	<p>Criminalize FT specifically as a serious offense, making it a predicate offense for ML purposes.</p> <p><i>Immediately implement any outstanding elements of the UN Security Council Resolutions relating to the provision and suppression of the financing of terrorist acts.</i></p>
III. Freezing and confiscating terrorist assets	-
IV. Reporting suspicious transactions related to terrorism	-
V. International Cooperation	-
VI. Alternative remittance	-

Reference FATF Recommendation	Recommended Action
VII. Wire transfers	Introduce legislative or administrative requirements addressing specifically the need to give enhanced scrutiny to wire transfers that do not contain complete originator information, although some examples of relevance are included in the list of examples of possible suspicious transactions included in the appendix to the Guidance Notes.
VIII. Non-profit organizations	-

Table 13. Other Recommended Actions

Reference	Recommended Action
Customer Due Diligence (CDD)	<p>Make mandatory the implementation of the provisions of the Basel Committee CDD paper.</p> <ul style="list-style-type: none"> <li>• Publish specific provisions covering additional measures for private banking businesses and politically exposed persons</li> <li>• Introduce an explicit requirement that, where a transaction or account relationship does not proceed, any funds accepted must be returned only to original source</li> <li>• Extend the provisions for non-face-to-face business to refer to electronic methods of financial services</li> <li>• Review the distribution of provisions between the Regulations and Guidance Notes, given the descriptive nature of the latter, with a view to strengthening and making more explicit the mandatory requirements of both.</li> </ul>
Law enforcement	<p>Consider the establishment of an asset forfeiture fund into which confiscated property could be deposited and applied for law enforcement purposes. An asset share mechanism may also be a useful addition to the authorities' power to deal with confiscated property. In addition, a legal mechanism allowing for confiscation without conviction (civil forfeiture) may also be a matter, which the authorities may wish to introduce.</p> <p><i>Consider increasing the number and scope of training courses and related activities for administrative, investigative, prosecutorial, and judicial authorities in relation to enforcing laws to combat ML and FT. Exchanges with foreign police forces working on AML/CFT issues would also be beneficial.</i></p> <p><i>The use of special investigative measures needs to be reexamined, with explicit introduction of all possible investigative measures on ML/FT in the work of the police.</i></p>
FIAU	<p>Consider augmenting the staff of the FIAU as the full implementation of its AML/CFT functions is achieved.</p> <p><i>The FIAU needs to take steps to improve further the AML/CFT awareness and knowledge of the reporting institutions, particularly those institutions and sectors that may have been underreporting suspicious transactions in the past. The FIAU needs to provide systematic feedback to institutions on STRs received.</i></p>

### **E. Authorities' Response**

199. The Maltese authorities are in general in agreement with the positive assessment and the conclusions reached by the FSAP Assessment Team on Malta's regime in compliance with the anti-money laundering and the combating of the financing of terrorism international standards.

200. The authorities accept the recommendations made by the assessment team and will take immediate measures to implement them. The authorities note that, at times, the recommendations require the inclusion of *best practice guidance* into the legislation. Where appropriate this will be done. In other instances, implementation may be made by way of mandatory directives to the industry issued by the respective authorities pursuant to enabling clauses in the relevant legislation—such as by the Financial Intelligence Analysis Unit and/or the relevant supervisory authority.

201. As stated in this report, the authorities believe that financing of terrorism is already adequately criminalized under existing Maltese penal legislation as required by the Convention for the Suppression of the Financing of Terrorism. However, the Maltese authorities take note of the positive recommendation to further strengthen the criminalization of the FT.