

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 Macroprudential 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.⁷ 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

⁷ 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"> • Consider introducing an explicit provision requiring the renewal of identification should doubts appear regarding identity in the course of the business relationship. • Consider introducing in the law or regulations a requirement in relation to the inclusion of name, address and account number when transmitting funds. • Supplement the current Guidance Note by introducing a specific legislative requirement to include originator information on fund transfers. • Establish a requirement for graduated customer acceptance policies, and additional focus on high risk customers <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"> • Publish specific provisions covering additional measures for private banking businesses and politically exposed persons • Introduce an explicit requirement that, where a transaction or account relationship does not proceed, any funds accepted must be returned only to original source • Extend the provisions for non-face-to-face business to refer to electronic methods of financial services • 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.
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.