

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

MFSA RULE 1 of 2012

FOREIGN CURRENCY LENDING

FOREIGN CURRENCY LENDING RULE ISSUED UNDER THE MFSA ACT

INTRODUCTION

1. In terms of Article 16(2)(a) of the MFSA Act [CAP 330] ('the Act'), the Competent Authority ('the Authority') as established under Article 3 of the Act may make Rules regulating the procedures and duties of persons licensed or authorised by it, or falling under its regulatory or supervisory functions. The Authority may amend or revoke such Rules. The Rules and any amendment or revocation thereof shall be officially communicated to financial institutions and the Authority shall make copies thereof available to the public.
2. The Foreign Currency Lending Rule ('the Rule') issued under the MFSA Act is being implemented pursuant to Article 16(2)(a) of the Act.
3. The Rule is modelled on the Recommendation of the European Systemic Risk Board on lending in foreign currencies (ESRB/2011/1) published as Notice No. 2011/C 342/01 of the Official Journal of the European Union, which was approved by the General Board of the European Systemic Risk Board (ESRB) on 21 September 2011, in accordance with Regulation (EU) No. 1092/2010.
4. High levels of foreign currency lending may have significant systemic consequences for Member States and can create conditions for negative cross-border spill-over effects. Excessive foreign currency lending has already given rise to financial stability concerns in a number of Member States. In some cases, these excessive levels contributed to the reinforcement of credit cycles, having potentially affected asset prices.
5. The risks associated with foreign currency loans are credit and market risks and funding and liquidity risks. Lending in foreign currency can also fuel excessive credit growth which has often led to asset price bubbles with adverse implications for financial stability.
6. The goals of the ESRB Recommendations are: (i) to limit exposure to credit and market risks, thus increasing the resilience of the financial system; (ii) to control excessive foreign currency credit growth and avoid asset price bubbles; (iii) to limit funding and liquidity risks and (iv) to improve risk pricing.

DEFINITIONS

7. For the purposes of this Rule the following definitions shall apply:

Authority: means the Malta Financial Services Authority established by Article 3 of the Act;

Credit Institution: shall have the same meaning as is assigned to it in the Banking Act 1994;

Financial Institution: shall have the meaning assigned to it in paragraph 9 of this Rule;

Foreign currency: shall mean any currency other than the legal tender of the country in which the borrower is resident;

Foreign currency lending: shall refer to all lending in currencies other than the legal tender of the relevant country;

Material lending: shall mean a level of lending which is deemed as material by the Authority in accordance with the European Banking Authority's Guidelines and/or as indicated by the ESRB from time to time'.

Monetary Financial Institutions (MFIs): shall have the same meaning assigned to it in Appendix 3 of Banking Rule BR/06/2007 - Statutory Financial Information to be submitted by Credit Institutions Authorised Under the Banking Act 1994;

Non-monetary financial institutions: shall cover the following sectors: non-financial corporations, financial auxiliaries, other financial intermediaries, insurance and reinsurance undertakings and pension funds, households and non-profit institutions serving households;

Residents: shall mean those residents which have a centre of economic interest in the economic territory of a particular country. These resident units may or may not have the nationality of that country, may or may not be legal entities, and may or may not be present on the economic territory of the country at the time they carry out a transaction.

Unhedged borrowers: shall mean borrowers without a natural or a financial hedge, meaning economic agents that are exposed to a currency mismatch. Natural hedges include in particular the cases where borrowers receive income in foreign currency (e.g. remittances/export receipts). For the purposes of this Rule, financial hedges normally presume a contract with a financial institution.

SCOPE AND APPLICATION

8. Unless otherwise specified, this Rule applies to all financial institutions as defined herein.
9. For the purposes of this Rule, 'financial institutions' means:
 - i. Credit Institutions authorised under the Banking Act [Cap. 371];
 - ii. Financial Institutions authorised under the Financial Institutions Act [Cap. 376];

- iii. Investment Services Providers and Collective Investment Schemes authorised under the Investment Services Act [Cap. 371];
 - iv. Undertakings authorised to carry on the business of insurance and/or re-insurance under the Insurance Business Act [Cap. 403];
 - v. Occupational schemes authorised under the Special Funds (Regulation) Act [Cap. 450];
 - vi. Financial Conglomerates in terms of the Financial Conglomerates Regulations [L.N. 521 of 2004].
10. Financial institutions shall implement the Principles found within this Rule in a manner proportionate to their size, nature and complexity of operations undertaken.
11. Unless otherwise specified, the Rule only covers unhedged borrowers.
12. The scope of this Rule is to outline the general principles regulating the conduct of foreign currency lending.
13. This Rule shall not prejudice the monetary policy mandates of the Central Bank of Malta and/or, as the case may be, the central banks in the Union, and the tasks entrusted to the ESRB.
14. The Authority shall monitor and control foreign currency lending at both consolidated and unconsolidated (solo basis) level, as it considers appropriate, in accordance with the provisions of relevant legislation.
15. The Authority may request any information which a financial institution is required to gather under this Rule.
16. The Authority shall implement the Rule in accordance with any applicable international agreements entered into under Article 4(4) of the Act.

PART 1: PRINCIPLES ON FOREIGN CURRENCY LENDING APPLICABLE TO INSTITUTIONS

Principle 1: Risk awareness of borrowers

17. Financial institutions engaged in foreign currency lending are exposed to indirect exchange risk as a component of credit risk through currency mismatches on their clients' balance sheets. Credit risk needs to be addressed by increasing borrowers' awareness of risks embedded in foreign currency lending by guaranteeing that they are given adequate information. It is essential that financial institutions provide comprehensive and transparent information, and uniform standards, to their customers (or prospective customers) for well-informed decisions by the latter. Appropriate information about the characteristics of products reduces adverse selection and credit risk on the part of the borrowers and addresses the asymmetric information between borrowers (customers) and lenders (financial institutions).

18. Financial institutions shall provide borrowers with adequate information regarding the risks involved in foreign currency lending. Such information shall be sufficient to enable borrowers to take well-informed and prudent decisions and should at least encompass the impact on their loan instalments of a severe depreciation of the legal tender of the Member State in which a borrower is domiciled and of an increase in the foreign interest rate.
19. Financial institutions shall to the extent possible offer their customers domestic currency loans for the same purposes as foreign currency loans as well as financial instruments to hedge against foreign exchange risk.
20. The Authority may require financial institutions to carry out an internal assessment of the possibility of offering equivalent loans in domestic currency to those offered in foreign currency, so as to assess their substitutability.

Principle 2: Creditworthiness of borrowers

21. Subject to paragraph 10, financial institutions shall monitor levels of their foreign currency lending and non-financial customers' currency mismatches, and adopt the necessary measures as and when required to limit foreign currency lending.
22. Credit risk can be addressed by ensuring that new foreign currency loans are extended only to borrowers that are creditworthy and capable of withstanding severe shocks to the exchange rate used.
23. Financial institutions shall only grant foreign currency loans to borrowers that demonstrate their creditworthiness, both at the beginning of a contract and throughout the duration of the contract, taking into account the repayment structure of the loan and the borrowers' capacity to withstand adverse shocks in exchange rates and in the foreign interest rate.
24. Financial institutions shall hold records on all foreign currency loans entered into following the coming into force of this Rule indicating *inter alia*:
 - i. the borrower's identity, as in whether it is a household or a non-financial corporation or otherwise;
 - ii. the borrower's country of residence;
 - iii. the currency of the loan; and
 - iv. the borrower's creditworthiness.
25. Pursuant to its monitoring role within *inter alia* this particular area, the Authority may set more stringent underwriting standards, as may be applicable or required such as debt service-to-income (DTI) triggers and loan-to-value (LTV) ratios. DTI and LTV ratios take the two major aspects in determining a borrower's credit standing into account: the collateral they can provide and their ability to meet the repayment obligations.

Principle 3: Internal risk management

26. Financial institutions should address the mispricing of risks associated with foreign currency lending by better incorporating foreign currency lending risks in their internal risk management systems.
27. Financial institutions granting foreign currency credit to unhedged borrowers shall incorporate in their internal risk management systems the specific risks entailed through this activity.
28. Financial institutions shall account for risks stemming from foreign currency lending both in their internal risk pricing and internal capital allocation.
29. In particular, credit institutions are required to hold adequate capital for foreign currency lending, in accordance with the requirements for internal capital adequacy assessment process (ICAAP) found in Banking Rule BR/12/2012 - The Supervisory Review Process Of Credit Institutions Authorised Under The Banking Act 1994.

Principle 4: Capital requirements

30. The Authority requires financial institutions to hold adequate capital to cover risks associated with foreign currency lending, particularly the risks stemming from the non-linear relation between credit and market risks.
31. In particular, credit institutions are required to implement specific measures under the Supervisory Review Process laid down in Banking Rule BR/12. Assessment in this respect shall be made by the Authority under its supervisory review and evaluation process (SREP) described in BR/12 and/or under legislation setting out capital requirements for credit institutions. If the capital held by credit institutions is considered to be insufficient to adequately address risks associated with foreign currency lending, the Authority may request credit institutions to increase their capital holdings for this purpose.

Principle 5: Liquidity and funding

32. Principle 5 applies to foreign currency lending to both hedged and unhedged borrowers undertaken by MFIs and financial institutions licensed under the Financial Institutions Act.
33. The relevant institutions shall monitor funding and liquidity risks in connection with foreign currency lending, together with their overall liquidity positions. Particular attention shall be paid to the risks related to:
 - a) any build-up of maturity and currency mismatches between assets and liabilities;
 - b) reliance on foreign markets for currency swaps (including currency interest rate swaps);

- c) concentration of funding sources.
34. The Authority may, if necessary, require these institutions to limit their exposures to the liquidity and funding risks, while avoiding a disorderly unwinding of current financial structures.
35. The relevant institutions shall for the purposes of internal risk management and compliance with the requirements of this Rule monitor on a regular basis their funding and liquidity conditions, which shall encompass, at the least, monitoring of the following indicators¹:
- (i) funding liabilities sourced from each significant counterparty/total assets²;
 - (ii) amount of foreign currency swaps (gross)/total liabilities, broken down by currency;
 - (iii) maturity mismatches between foreign currency assets and foreign currency liabilities (for each relevant currency) vs. maturity mismatches between domestic assets and domestic liabilities, for the most relevant time buckets³, as may be defined by the Authority;
 - (iv) currency mismatch between assets and liabilities.

PART 2: SUPERVISORY PROCESS

36. The Authority shall carry out supervision on foreign currency lending activities in line with Recommendations C and G on credit growth induced by foreign currency lending and reciprocity respectively, contained in the Recommendation of the European Systemic Risk Board on lending in foreign currencies issued on 21 September 2011.
37. Whilst noting that the Rule is addressed to financial institutions, the Authority still deems it appropriate to implement as principles the two recommendations hereunder. The disclosure of the Authority's supervisory process in the Rule is aimed to provide licence holders and other stakeholders with a transparent viewpoint as to how the Authority would carry out the monitoring of foreign currency lending in financial institutions.

Credit growth induced by foreign currency lending

38. Without prejudice to paragraph 10 above, the Authority shall in consultation with the Central Bank of Malta, monitor whether foreign currency lending is inducing excessive credit growth as a whole and, if so, whether such growth

¹ Indicators (i) and (iii) are similar to indicators used as monitoring tools, as proposed by 'Basel III: International framework for liquidity risk measurement, standards and monitoring', December 2010.

² This indicator corresponds to Basel III monitoring tool III.2 on funding concentration, 'Basel III: International framework for liquidity risk measurement, standards and monitoring', December 2010.

³ This indicator corresponds to Basel III monitoring tool III.1 on contractual maturity mismatches 'Basel III: International framework for liquidity risk measurement, standards and monitoring', December 2010.

requires the adoption of new or more stringent rules than those set out in Principle 2.

Reciprocal measures

39. The Authority shall impose measures addressing foreign currency lending which are at least as stringent as the measures in force in the host Member State where local financial institutions operate through provision of cross-border services or through branches. This principle applies only to foreign currency loans granted to borrowers domiciled in the host Member States. Where relevant, the measures should be applied at the individual, sub-consolidated and consolidated levels.
40. The Authority may publish on its website the measures communicated to it by host supervisors of the Member States where local financial institutions operate through provision of cross-border services or through branches. Where the Authority is acting as a host supervisor it shall communicate all current and new measures to address foreign currency lending to all relevant home supervisors and to the ESRB and the EBA.

SUBMISSIONS TO THE AUTHORITY

41. Financial institutions identified by the Authority as undertaking material lending activities in foreign currency shall fill in the templates specified in Annexes A and B and submit them to the Authority on a quarterly basis, or as may be specified by the Authority. The templates should be submitted within one month from the end of each reporting period.
42. Financial institutions required to report to the Authority in accordance with paragraph 41 and which have not carried out any foreign currency lending during the period under review, shall submit a nil return.

IMPLEMENTATION

43. This Rule shall come into force on 1st January 2013.