

# **MFSA**

---

**MALTA FINANCIAL SERVICES AUTHORITY**

**REQUEST FOR PROPOSAL FOR  
ASSET QUALITY REVIEW:**

**BANKING BOOK AUDIT**

**AND**

**REAL ESTATE APPRAISAL**

**April 2015**

## **Contents**

Introduction: Background and objectives

1. Scope of the Banking Book Audit and the Real Estate Appraisal
2. Key tasks of the exercise
3. Key delivery dates
4. Elements to be included in the proposal document
5. Next steps and contacts
6. Selection Criteria to be applied by the MFSA
7. Deliverables

Appendix 1: Conflicts of interest

Contacts:

National Project Management Office (NPMO) Lead: Mr Karol Gabarretta  
(MFSA Banking Supervision Unit)

**Bank selected for AQR: Mediterranean Bank plc**

## **Introduction: Background and objectives**

The establishment of a Single Supervisory Mechanism (SSM), entrusting the European Central Bank (ECB) with responsibility for the supervision of banks in the euro area, came into effect on 4<sup>th</sup> November 2014. Pursuant to the requirements of the SSM, the ECB, together with the National Competent Authorities (NCAs), has determined that a comprehensive assessment (CA), including an Asset Quality Review (AQR), shall be carried out at certain specified institutions that may, in the future, be classified as significant credit institutions of the participating Member States for the purposes of the SSM.

Locally, one institution, namely Mediterranean Bank plc, has been identified as qualifying to be subject to the CA during 2015. The AQR, in the form of a risk-based, targeted exercise, will include an analysis of the bank's data on relevant credit and securities portfolios and the review of the bank's related risk processes.

The nature and scope of the exercise is defined in the Asset Quality Review Phase 2 Manual (Version 2.0) issued by the ECB on the 21<sup>st</sup> of February 2014, as updated from time to time, and any relevant guidelines and, or documentation issued by the ECB in this regard (hereinafter jointly referred to as 'the Manual') and any other guidelines and/or documentation as may be issued by the ECB from time to time. The Manual, to which applicants will have to adhere, prescribes and details the tasks to be performed.

### **1. Scope of the Banking Book Audit and the Real Estate Appraisal**

The AQR, in general, and thus the Banking Book Audit in particular, is intended to be performed on Mediterranean Bank plc (hereinafter referred to as 'the bank'). The AQR's scope extends to all assets in the balance sheet of the bank at the highest level of consolidation within the Eurozone. As such, non-domestic exposures stemming from foreign subsidiaries may be in scope.

The exercise will be focused on the most recently available accounting and prudential figures.

Not all portfolios may be subject to Loan File Reviews (LFR). Only those portfolios identified by the ECB and the National Project management Office (NPMO) within the Malta Financial Services Authority (MFSA) as being material from a risk perspective will be analysed. For the avoidance of doubt, risk parameters may still be calculated for the wider portfolio to support verification of collective provisioning and as an input for stress testing.

The LFR will be performed on a sample of loans selected from the identified portfolios. The sample will be selected by the applicant in accordance with the Manual. The sample will be selected randomly, over-weighting larger and riskier exposures. Nevertheless, it is expected that the sample selected would be made immediately available to the NPMO.

As part of this AQR, the MFSA, in coordination with the ECB, *may* also carry out an appraisal on Real Estate collateral backing the bank's loan portfolio, insofar as this may be

applicable. A sample of Real Estate assets of different types will be delivered to the selected candidate for appraisal. This sample may contain random collaterals and foreclosed assets.

It is envisaged that this part of the AQR exercise will be conducted entirely through the support of external experts/audit firms and appraisers. In this regard, the MFSa invites qualified persons and/or entities to submit proposals regarding the tasks that need to be undertaken.

## **2. Key tasks of the exercise**

The selected candidate will be required to perform the following tasks:

### For the purposes of the Banking Book Audit:

- *Policies, Processes and Accounting* - The acquisition of an informed understanding of the bank's policies and processes, concerning, amongst others, non-performing loan (NPL) management and allocation of collateral values and calculation of Loan to Value ratios (LTVs). This review will also consider questions related with the application of rules and policies, such as impairment definitions, identification of forbearance, etc. The Banking Book Audit may extend to other banking book assets;
- *Data integrity validation on selected portfolios* – The selected candidate will be required to perform basic data checks on the information provided by the bank, including but not limited to: completeness (e.g. analyses on empty fields, cross-checks between client, collateral and loans for completeness), integrity and validation checks (e.g. checks on outliers, repetitive patterns in data), consistency (e.g. cross-checks within segments, across segments and banks), timeliness (e.g. appraisal dates), assessment of key metrics vs. policy, etc. If required, the selected candidate will ensure that loan tapes have been adequately corrected to perform sample selection and will notify the NPMO accordingly;
- *Sample selection on selected portfolios* – The selected candidate, in conjunction with the NPMO, will select from the validated information a sample of customer connections for further analysis. The sample will be selected randomly, though the sample should be over-weighted with riskier and larger customer connections. Sampling rates are to be decided upon in accordance with the methodology outlined in the Manual. Such methodology will be applied by the selected candidate and verified by both the NPMO and the ECB. Coordination will be required between the team of banking book auditors providing data on the collateral and the team of real estate valuers. The selected candidate is required to provide regular progress reports on a fortnightly basis to the NPMO in this regard;
- *LFR and impairment verification on selected sample* – The selected candidate will perform a review of the classification of the customer connections as guided by applicable EBA Implementing Technical Standards (EBA Standards) around NPLs. For customer connections with evidence of impairment, the selected candidate will also assess the appropriate impairment provision in line with applicable accounting standards (IFRS as adopted by the European Union) and further specific direction as may be provided by the ECB. Additionally, the following tasks are to be covered as part of the LFR:

- Identification of forbearance and restructured operations;

- Estimation of impairment shortfalls in the exposures reviewed;
  - Verification of adequacy of provisioning levels; and
  - Any other task which may be required by the NPMO and, or the ECB.
- *Verification and adjustment of collective provisioning models* – The selected candidate will review the collective provisioning models used by the bank, ensuring that methodologies, segmentation and parameterisation are in line with market standards and that definitions used are consistent with EBA Standards. Where deviations are found, the impact shall be quantified;
  - *Determination of basic, portfolio level risk parameters (such as observed default rate)* – As part of verifying the collective provisioning model parameterisation and to act as an input to stress testing analysis, the selected candidate will be asked to perform analysis of basic risk parameters such as point-in-time default rate and cure rate at a sub-portfolio level. Calculation of the specific parameters and the segmentation to be applied will be defined by the ECB;
  - *Extrapolation and estimating impact on CET1 Capital ratio* – The adjustment to specific impairment provisions for the sample will be translated into an overall impact on the relevant sub-portfolio (reflecting skews in the sample). This will then be combined with findings from collective provisioning analysis to arrive at an adjustment to the impairment provisions for the bank balance sheet. This will then be translated into an impact on the CET1 capital ratio reported by the bank according to a scheme provided by the ECB. For the avoidance of doubt, the selected candidate will not be required to validate the CET1 capital ratio calculation;
  - *Delivering a report describing findings from the review* – The report will describe the findings from each element of the above. The report will also include qualitative scoring of relevant bank processes according to a framework set out by the ECB. The NPMO may require specific meetings to be held with the selected candidate to discuss the outcome of these reviews;
  - *Coordinating other external support* – and, if applicable;

For the purposes of the Real Estate Appraisal:

- An appraisal of the bank's collateral held in the form of real estate properties through a sample of assets that shall include housing, office buildings, commercial facilities, developments in progress and land of all kinds. Such valuations should be carried out on the basis of 'market value', consistent with internationally accepted best practices, such as the Royal Institute of Chartered Surveyors (RICS) etc;
- Desktop runs and drive-by valuations, following a risk-based selection of assets;
- Other types of valuations as may be required, such as shipping and aircraft appraisals or other assets, which would also need to be valued according to recognised international standards; and,

- Consistency checks on collateral valuations;
- Utilisation of such valuation of collateral with the rationale of verifying the correctness of the information and the accuracy and timeliness of the valuation that the bank provides as input to the AQR.

Although it is envisaged that the main tasks of the selected candidate in relation to Real Estate Appraisal would be focused on the valuation of properties within Malta, the selected candidate may also be required to value any properties held as collateral by the bank in other countries. The applicant binds himself to carry out market valuations in foreign countries, if required.

In their proposal, applicants should also explain whether they would be able to provide historical time-series of real estate properties. The breakdown would, at a minimum, include different asset types and, if applicable, regions.

Statistical valuation of assets and/or groups of assets will also be considered. Applicants with these capabilities are expected to describe them in their proposal, detailing at least the scope and minimum requirements for this type of assessment.

The selected candidate may also be required to carry out any other tasks which may be requested by the NPMO and, or the ECB during the course of this exercise. The selected candidate must take responsibility for coordinating its banking book auditors and real estate valuation and similar experts, as well as other third party firms such as PMO support.

### **3. Elements to be included in the proposal document**

Applicants interested in carrying out this mandate should submit a proposal including, at least, the following items:

- Details of experience in carrying out large scale exercises of this nature within Malta and/or Europe or elsewhere;
- Details of market knowledge in Malta and understanding of historic and current local market conditions;
- Details of the composition and number of the proposed team (citing relevant experience) together with CVs of the key personnel who will take responsibility for the tasks assigned (including compilation of the required deliverables) throughout the duration of the entire exercise;
- A detailed project plan as to how the applicant proposes to undertake the exercise holistically;
- A methodology statement setting out details of how the applicant will ensure that the timetable is met and the quality assurance process that will be put in place;
- The ability of the applicant to provide deliverables and/or results, as applicable, in phases

prior to the deadline;

- In relation to the Banking Book Audit, a schedule of proposed rates per hour /per file (based on the average number of man hours it would take to review a file);
- In relation to the Real Estate Appraisal, a schedule of the applicant's proposed rates per appraisal (based on the average number of man hours it would take to review relevant documentation and differentiated by type of valuation), with details of volume discounts if applicable;
- An explanation of how the results of the review would be delivered;
- Full disclosure as to how any conflicts of interest will be managed or eliminated by the applicant;
- Full disclosure as to how confidentiality would be safeguarded.

The selected applicants would, for the purposes of carrying out the AQR, be appointed as inspectors in terms of Article 22 of the Banking Act (Chapter 371 of the Laws of Malta) and would be bound by the relevant provisions of the Banking Act (specifically Article 34 of the said Act) and the Professional Secrecy Act (Chapter 377 of the Laws of Malta).

The selected applicant shall also be required to act in consultation with the NPMO as may be required.

If the MFSA considers that the selected candidate has materially breached the provisions agreed upon, is not meeting the agreed timelines or is not submitting work of the level of quality required, the MFSA reserves the right to terminate the agreement with the selected candidate with immediate effect and to appoint another person in order to carry out and, or complete the AQR.

In such case, the originally selected candidate shall be required to collaborate with the NPMO and with the appointed person and, subject to the relevant confidentiality obligations, to exchange any information as may be required in order to allow the appointed person to carry out and, or complete the AQR.

#### **4. Key dates**

The latest date for the submission of proposals by applicants is **17.00 hours, 17<sup>th</sup> April 2015**. Following this date, the MFSA may open a process of Q&A in which the applicants might be requested to amend part of their proposals or to provide additional information. The tentative period for this Q&A process will be **24<sup>th</sup> April 2015**. The final decision will be communicated to the applicants and the general public by not later than the **30<sup>th</sup> April, 2015**.

This CA is thus expected to commence in May 2015. The deadline for the completion of the AQR shall be established by the ECB in due course. The selected candidate shall be required to complete the AQR within the deadline set by the ECB, provided that the expiration of the deadline shall not relieve the selected candidate from completing any pending

obligations.

All the elements included in this Request for Proposal, such as proposals, reports, results, etc. will be disclosed to the ECB and to any other experts acting as the latter's agents. The contact person at the MFSA is Mr Karol Gabarretta (NPMO Lead), while the National Steering Committee (NSC) Chair is Prof Joseph Bannister.

## 5. Selection Criteria to be applied by the MFSA

<b>CRITERIA</b>	<b>RECOMMENDED WEIGHTING</b>	<b>KEY CONSIDERATIONS</b>
<b>Plan of Approach</b>	<b>45%</b>	<ul style="list-style-type: none"> <li>• Understanding and meeting of business needs by the applicant.</li> <li>• The methodology of approach the applicant proposes to use to deliver the required services on time, efficiently and to the highest standard.</li> <li>• References with respect to AQR for regulatory and / or supervisory authorities.</li> </ul>
<b>Pricing/Cost</b>	<b>30%</b>	
<b>Quality of Team</b>	<b>20%</b>	<ul style="list-style-type: none"> <li>• The professional and international capabilities/ expertise of each member of the team including relevant market experience in SSM countries/ Europe.</li> <li>• Capacity to guarantee continuity and act as a team with the NPMO throughout AQR exercise.</li> <li>• Details of relevant contracts including past experiences undertaken by the team proposed by the applicant.</li> </ul>



<p style="text-align: center;"><b>Extension of activities to other asset classes</b></p>	<p style="text-align: center;"><b>5%</b></p>	<ul style="list-style-type: none"> <li>• In what way does the applicant intend to deliver the services for other asset classes on time, efficiently, to the highest standard and in an integrated manner.</li> <li>• Single firm providing all the services or demonstrating strong ability to lead and manage a group of suitably experienced experts.</li> </ul>
--	--	--

Selection of the applicant shall be effected in accordance with the weighting specified in the table above.

## **6. Deliverables**

Deliverables shall be prepared and submitted in accordance with the methodology laid out in the Manual or as may be directed by the ECB during the course of this exercise.

The final deliverables to be submitted by the selected candidate shall, subject to any requirements which may be issued by the ECB from time to time, include, at least, the following components:

- Introduction and context;
- Scope of the work and purpose of the report;
- Main limitations to the analysis;
- Methodology used and assumptions made;
- Banking book overview;
- Summary of findings; and
- Detailed results for each one of the possible tasks specified above.

The selected candidate is expected to keep the NPMO regularly informed on progress made and to provide interim reports on the progress of the work and compliance with the scheduled deadlines. Such information and reports are to be submitted at least every two (2) weeks to Mr. Karol Gabarretta at [kgabarretta@mfsa.com.mt](mailto:kgabarretta@mfsa.com.mt), and if requested, to the ECB. In addition, the selected candidate is also expected to be available to discuss interim results on specific cases both locally and abroad with the NPMO and/or the ECB (and their representatives).

All the intermediate and final deliverables have to be submitted in English. It is to be noted that interim and final reports prepared by the selected candidate may be distributed to the bank, the Central Bank of Malta, the European Banking Authority, the ECB and to any other expert acting

as the ECB's agent. In addition, parts of the findings may be disseminated to the general public.

Results of the quantitative analyses and the appraisal exercise will be presented in a homogenized manner, in accordance with the Manual or as may be directed by the ECB during the course of this exercise.

---

**National Project Management Office  
c/o Banking Supervision Unit**

**Malta Financial Services Authority**

## **Appendix 1: Conflicts of interest**

The MFSA is duty bound to adhere to the highest possible standards to avoid conflicts of interest. As such, in the context of this Banking Book Audit and Real Estate assets valuation, the MFSA will review and analyse these potential conflicts of interest as a key element for the selection of the applicant. The conflicts of interest can be either absolute or partial. Applicants are expected to report both, and in the case of the latter, explain how they plan to mitigate them. Additionally, applicants will be required to explain how they will avoid potential upcoming conflicts of interest, should they be awarded the tasks involved.

*Absolute conflicts of interest* - There shall be presumed to be a conflict of interest if:

- The applicant has an economic interest that depends on the value of the real estate properties in question;
- The applicant has provided the bank with auditing services in either of the past two financial years or is engaged to do so in 2015;
- The applicant is involved in any cause of absolute incompatibility or recusal according to the professional deontological codes;
- The applicant considers that a cause of absolute conflict of interest applies, following its internal codes and ethics.

*Partial conflicts of interest* – A potential partial conflict of interest may exist if:

- The applicant's subsidiaries or affiliates are held in any of the absolute conflicts of interest described above;
- The applicant, its subsidiaries or affiliates have had, during the past two financial years, or have on-going business relationships with the bank;
- The applicant, its subsidiaries or affiliates are involved in any cause of partial incompatibility or recusal according to the professional deontological codes;
- The applicant considers that a cause of partial conflict of interest applies, following its internal codes and ethics;
- An individual member of the team proposed for this engagement is held in any of the causes of conflict of interest, either absolute or partial, acting as an individual professional or under the on-going professional relationship with the applicant or past professional relationships with other service providers.

In order to avoid conflicts of interest, applicants are required to submit, at least, the following information:

- A declaration on whether the applicant has any conflicts of interest, either absolute or

partial, with the bank, according to any of the causes described above. Should any conflict of interest be identified, this declaration should contain enough detail about the nature, scope, parties involved and timeframe of the mandate;

- A description of how the applicant intends to mitigate existing partial conflicts of interest, considering alternatives such as those included in the following illustrative and non-exhaustive list:

- Ensure that there are strict ‘Chinese walls’ around the execution team;
- Give the NPMO the option to recuse individual members of the team based on their past professional relationships with the bank;
- Ensure the highest confidentiality standards;

- A description of how the applicant plans to avoid potential conflicts of interests arising during the timeframe of this mandate and six months after it, at least until the results of the AQR and the CA are put into the public domain. The following illustrative and non-exhaustive list includes some of the options that could be considered:

- The routine conduct of conflict checks;
- The establishment of an internal control process to ensure that upcoming engagements are not conflicted with this one;
- The prompt notification to the NPMO of the emergence of any potential conflict of interest and a subsequent agreement with the NPMO on the course of action;
- The restriction of the nature and scope of upcoming engagements during the timeframe of this mandate;

Should an applicant have a (potential) conflict of interest and should the applicant not be able to prove that it has taken the necessary safeguards to ensure that such conflicts of interest do not, in any way, have any adverse effect on the delivery of the services, this may lead to either the limitation of the scope of the mandate or the exclusion of the applicant.