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GANADO
ADVOCATES

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NEWSLETTER

News Items & Industry Updates
Maltese Courts Updates
EU Legislative Updates
Questions & Suggestions

IN THIS ISSUE

3
News Items & Industry Updates

7
Maltese Courts Updates

9
EU Legislative Updates

13
Questions & Suggestions

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INTRODUCTION

Dear colleagues and friends,

It is a pleasure for us to send you the fourth edition of the BANKING AND FINANCIAL INSTITUTIONS newsletter by the Banking and Finance team at GANADO Advocates.

This edition seeks to build on the information provided in previous editions and to continue to provide you with some insights into the major changes taking place which are of relevance to the banking and financial industry. In particular, the newsletter includes:

i. Maltese court updates with a specific focus on a recent judgement focusing on Maltese insolvency legislation; and
ii. Selected European legislative updates, with a spotlight on the ongoing implications of the European Bank Recovery & Resolution Directive (BRRD) and anticipated developments in relation to the proposed recast Depositor Guarantee Compensation Scheme.

The past months have been very eventful for us at GANADO Advocates. We have participated in the Allen & Overy World Universities Comparative Law Project which was possible through our collaboration with Professor Philip Wood. Furthermore, during the month of June we have hosted the 2014 Lex Mundi Bank Finance and Regulation Practice Group Global Meeting. These initiatives allow us to keep an international perspective of the legal world which is fundamental in an increasingly cross-border banking and financial industry.

I do hope you will find this newsletter of use. Should you have any queries or suggestions to make or should you know of anyone who might be interested in receiving this newsletter in the future, please do not hesitate to contact me at cportanier@ganadoadvocates.com or Dr Leonard Bonello at lbonello@ganadoadvocates.com. We would be more than pleased to hear from you.

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NEWS ITEMS AND INDUSTRY UPDATES

GANADO Advocates host Lex Mundi Banking Practice Group

GANADO Advocates hosted the 2014 Lex Mundi Bank Finance and Regulation Practice Group Global Meeting in Malta on the 12 and 13 June.

Lex Mundi is a leading network of independent law firms with in-depth experience in 100+ countries. Lex Mundi member firms are able to offer clients preferred access to more than 21,000 lawyers worldwide – a global resource of legal knowledge and skills.

The 2014 Lex Mundi Bank Finance and Regulation Practice Group was attended by participants from Austria, Italy, Portugal, Poland, Switzerland, Slovakia, Czech Republic, Netherlands, Luxembourg, Hungary, Ireland, Belgium, Texas and Malta. The practice group meeting was an opportunity for participants from member firms to discuss and exchange views on a number of developments taking place in the global banking industry.

The Recast Deposit Guarantee Schemes Directive

The recast Directive on Deposit Guarantee Schemes ("DGSD") adopted in April 2014 brings the EU another step closer to the Banking Union pursued following the financial crisis.

The original directive adopted in 1994 was one of minimum harmonisation, resulting in differences between Member States on the rules applicable to deposit guarantee schemes ("DGS"), in particular differences between DGS on level of coverage, scope of covered depositors and products, payout period and DGS funding requirements. In 2009 a harmonised increase in coverage was required and in 2010 the Commission proposed a comprehensive review of the original directive.

The following are main features of the DGSD which the banking sector should note:

DGS Funding

DGS are to be funded by ex ante contributions received at least annually and by July 2024 this should reach at least 0.8% of the amount of covered deposits (in limited circumstances, a lower target of not less than 0.5% is permitted). Payment commitments can account for up to 30% of the target level in accordance with guidelines. Additional limited ex post contributions may be necessary.

Contributions

The bank's contributions will not be based on amount of covered deposits only but also on the degree of risk incurred by it. This will have an impact on the contribution made by a bank and may encourage a lower risk profile. DGS calculation methods for risk based contributions will be subject to guidelines and approval.

Cover

Harmonised €100,000 per depositor, with higher coverage by way of exception in specific cases.

Payment period

As a general rule, the period within which depositors must be able to access their funds will gradually be reduced from 20 working days to 15 working days (as from 01.01.2019) to 10 working days (as from 01.01.20121) to 7 working days (as from 01.01.2024).

Information to depositors

Prospective depositors must be given a standardised information sheet containing information about their coverage and the responsible DGS and the bank must ensure it obtains acknowledgement of same using the template provided. Existing depositors must be provided with updated standardised information on their statements of account. Advertising of deposit products must also be limited to factual information. The bank will thus have to pay close attention to the content and timing of information provided by them.

Information to DGS

The DGS must be provided with prompt access to information on deposits whenever this is requested under the DGSD. The bank must therefore, inter alia, tag eligible deposits and ensure its records are always up to date.

Single point of contact

The DGS remain responsible for banks in their jurisdictions, however for the benefit of depositors each DGS will also be the single point of contact for (and will inform and repay) depositors of local branches of banks which are authorised in another Member State. This is mandatory but national DGS can pursue certain measures on a volunatry basis, such as cross-border schemes (insofar as a single EU DGS is not feasible at this time) and lending to each other.

The above are some highlights of the DGSD and while banks necessarily already have procedures in place in connection with deposit guarantee schemes, they should carefully consider the impact on their existing arrangements and systems to ensure full compliance with any specific or additional requirements under the DGSD.

University of Malta Students complete Allen & Overy World Universities Comparative Law Project

In May 2014, lawyers from GANADO Advocates assisted a selected few students from the University of Malta in relation to the World Universities Comparative Law Project regarding Malta, which is designed by the Allen & Overy Global Law Intelligence Unit. The project and the Allen & Overy team are headed by Prof. Philip R Wood, one of the world's leading comparative lawyers and practitioners. The students from the University of Malta that participated were Timothy Borg Olivier, Thomas Bugeja, Nicola Jaccarini and Karl Tanti. The students were assisted both by members of the Faculty of Law at the University of Malta (namely Prof. Andrew Muscat and Dr. David Fabri) and by a practitioners panel (namely Dr. Conrad Portanier, Dr. Beppe Sammut and Dr. Catherine Formosa).

The project involved the completion of a legal questionnaire, which provides a set of legal ratings of selected jurisdictions in the world carried out by students at leading universities in the relevant jurisdictions. The questionnaire assesses aspects of Maltese law with a view to rating the law in the relevant areas, and is concerned primarily with wholesale financial and corporate law and transactions, and not with retail law.

By and large, Malta ranked well in the survey with more than half of the replies evidencing Malta as a commercially friendly jurisdiction for the carrying out of international financial business in or from Malta. In fact, Malta ranked highly in relation to insolvency set-off, universal trusts, governing law, ownership of land, foreign direct

investment, exchange controls and class actions (amongst others). This is a result of the legislative changes that have been made to render Malta a more competitive and attractive jurisdiction for international finance over the last 10 to 15 years. In fact, over the last two decades, significant legislative changes have been made that support Malta's role as an international financial centre of repute. The more important changes have naturally been in taxation and in the banking, insurance, funds, investment services and pensions regulatory regimes. Significant – though less well-publicised – legislative innovations have also been introduced to make Maltese law more creditor friendly. These innovations have enabled, inter alia, the use of a security trustee, set-off and netting on insolvency, subordination, factoring, the assignment and pledging of future debts, and security by title transfer.

Notwithstanding, there are still several areas of Maltese law which may pose problems to those interested in carrying out business in or from Malta, and these area were identified by the students in the questionnaire. Such issues included:

1. the uncertainty in Maltese legal circles regarding the enforcement of security by lenders (that is whether this can take place out of court or solely through the courts);
2. the uncertainty regarding the termination of loans (and other contracts) between sophisticated parties on the happening of certain events (usually an event of default), and whether a party can unilaterally terminate the agreement or whether only a law of Court can pronounce itself on the issue;
3. the ad valorem registration tariff for hypothecs which may be seen to be deterrent factor in the registration of general and special hypothecs under Maltese law, since the same tariff is calculated based on the value of the hypothec to be registered; and
4. the costs and delays of litigation in the Courts of Malta. It was submitted by the students that legislative intervention is required to solve the above-mentioned issued.

A full copy of the questionnaire can be found here.

Court of Appeal confirming ranking of VAT Department notwithstanding failure to register its special privilege

On 28th March 2014, the Court of Appeal, composed of Chief Justice Silvio Camilleri, Mr. Justice Tonio Mallia and Mr. Justice Joseph Azzopardi, in the case Bank of Valletta vs. Crown Hotels Ltd, held, amongst others, that Bank of Valletta p.l.c. (the "Bank") had a right of preference to recover all judicial expenses incurred by it, before all other creditors of Crown Hotels Ltd ("Crown"). Furthermore, the Court confirmed the decision of the First Hall Civil Court that the VAT Department still ranked prior to the Bank for payment of fiscal amounts due by Crown to the VAT Department, even though the VAT Department had failed to register its special privilege over the immovable property owned by Crown.

This case involved the ranking of creditor proceedings of three creditors of Crown, namely the Bank, the Inland Revenue Department (the "IRD") and the VAT department. In its judgment on 27th June 2006, the First Hall Civil Court held that the IRD ranked before both the VAT department and the Bank and further held that the VAT department had a preference for payment on the proceeds of the Court auctioned sale of the immovable property owned by Crown, even though the VAT department had failed to register its special privilege over the immovable property with the Public Registry. Furthermore, the Court declared that the €135,000 which was deposited in Court should be taken by the Director General of the IRD on account for sums due by Crown, and whose claim ranked before the VAT Department and the Bank. Here, the Court considered that the claim of the IRD ranked with priority over the deposit in court, which is a movable, disregarding the fact that the sale proceeds which were deposited were obtained through a court sale of the immovable property owned by Crown.

The Bank appealed this decision and requested, firstly, that the Bank be first paid in respect of all judicial expenses incurred by it in relation to its claim and the auction, and secondly, that the Bank be given priority and preference ahead of the VAT Department over the proceeds from the sale by auction of the immovable property.

In relation to the Bank's first plea, the Court, by making reference to several other Maltese judgments, agreed with the Bank and concluded that the Bank had the right to be repaid for all judicial expenses incurred by the Bank in relation to the acknowledgement of the claim and the court auction, and this above all other creditors

of Crown. By giving priority to the Bank in respect of the judicial expenses incurred by it in enforcing its rights and proceeding with the judicial sale of the immovable property, the Court recognised that these costs ultimately benefitted the creditors of Crown generally and consequently ruled in favour of the Bank.

In relation to the Bank's second plea regarding the privilege of the VAT department, the contentious issue in this respect was the interpretation of Article 62 of the Value Added Tax Act which reads as follows:

> "The Commissioner shall have a special privilege over the assets forming part of the economic activity of a person in respect of any tax due by that person under this Act and the said tax shall, notwithstanding anything contained in any other law, be paid in preference to a debt having any other privilege, excepting a debt having a general privilege and a debt mentioned in article 2009(a) or (b) of the Civil Code".

Here the Court stated that while special privileges over movables need not be registered (Article 2032 of the Civil Code), special privileges over immovables had no effect unless registered in the Public Registry. This is due to the fact that special privileges over immovables comprise the diritto di seguito and registration is therefore necessary in the interest of third parties. However, the Court, by making reference to Zammit vs. Caruana noe' (8th January 1958), held that while Maltese law did not provide that the special privilege of the VAT Department ranked with preference, the law did state that the said tax shall, notwithstanding anything contained in any other law, be paid in preference to a debt having any other privilege. The Court held that the claim for the payment of a debt and the privilege were separate, and although a privilege could not exist without a claim, a claim could exist independently from a privilege. Therefore, failure of the VAT Department to register the privilege did not extinguish its claim, and accordingly, this claim had to be paid with preference to those of other privileged debts, including that of the Bank, as stated in the same article 62 of the Value Added Tax Act.

The above judgment is just one of many conflicting judgments in relation to the ranking of creditors and the resulting proceedings in following the insolvency of a company. The decision of the Court that the privilege and the claim are separate may seem to run counter to the spirit of the law and the generally accepted interpretation of the relevant article in Maltese legal circles, since from a reading of the law it would seem that the VAT Department has the right to receive payment ahead of other privileged debts solely due to the fact that it has registered its special privilege with the Public Registry. The registration of the privilege by the VAT Department and the claim to receive payment ahead of all other privileged debts are intrinsically linked, and failure by the VAT Department to register its special privilege should result in it losing its 'privilege' to receive payment ahead of other privileged debtors. This case further evidences the need for legislative intervention in this area to clarify the position once and for all, and to give banks and other lenders the required comfort that the privileged status that they attain when obtaining security is maintained and respected during ranking of creditor proceedings on the insolvency of borrowers.

European Bank Recovery & Resolution Directive

Part 1

The Bank Recovery and Resolution Directive (Directive 2014/59/EU) of 15 May 2014 (the "BRRD") has just been published on the Official Journal of the European Union. Member States must apply the provisions of the BRRD as from 1 January 2015, except for the bail-in tools which will only become applicable as from 1 January 2016. In this two-part article, we try and select the most pertinent aspects of the BRRD and briefly analyse how it will impact the banking sector generally. Part II will be published in the next issue of the newsletter and will delve deeper into the bail-in tools and some key private law aspects of the BRRD.

Bank Recovery and Resolution Directive

Since, as we all know, Malta's banking sector was not significantly affected by the financial crisis, our legislator did not feel the need to legislate for special resolution tools in the case of banks and in fact Malta was one of the few Member States not to have a new banking resolution regime post-financial crisis. The BRRD represents the European Union's response to the resolution of banks and large investment firms (those which are required to hold initial capital of €730,000 by the CRD IV). The BRRD is a framework directive and most of the detail will be left to delegated acts and regulatory technical standards to be developed by the European Banking Authority and adopted by the European Commission.

The main elements of the BRRD are as follows:

- it establishes a minimum harmonization regime for the resolution of banks and investment firms in the European Union designed to ensure the continuity of its critical functions and restoration of the viability of all or part of that institution, while the remaining parts are put into normal insolvency proceedings

- it requires institutions to draw up detailed recovery plans setting out actions to be taken to restore long-term viability in the event of a material deterioration in its financial circumstances

- it requires establishment of a resolution authority in every Member State which is functionally and operationally separate from the banking regulator

- using the recovery plan as a basis, the resolution authority, in consultation with the competent authority, will prepare a resolution plan for each institution setting out options for resolving the institution in a range of scenarios

RTS on Minimum Amount of Professional Indemnity Insurance required under the Credit Mortgage Directive

The European Banking Authority recently published the final draft regulatory technical standards on the minimum monetary amount of the professional indemnity insurance cover (or comparable guarantee) required to be held and maintained by mortgage credit intermediaries falling under the scope of the Directive on credit agreements for consumers relating to residential immovable property (i.e. the Mortgage Credit Directive. The draft RTS set the minimum monetary amount of the PII (or comparable guarantee) by specifying the following amounts: €460,000 for each individual claim, and €750,000 for an aggregate amount per calendar year for all claims.

These draft RTS were developed in accordance with the Credit Mortgage Directive and have been sent to the European Commission for completion of the legislative process.

ECB issues draft list of Significant Banks for the purposes of the Single Supervisory Mechanism

Last June, the European Central Bank published a draft list of credit institutions which have been notified of the ECB's intention to consider them to be 'significant' banks for the purposes of the Single Supervisory Mechanism. The list shows the credit institutions together with their subsidiaries established in the Euro area, which are considered to form a single banking group.

Circa 195 euro zone member banks have been deemed by the ECB to be 'significant' banks, with 21 German banks included in the list, making Germany the most 'represented' country in this respect. Three Maltese banks were considered to be 'significant' banks and form part of the list, namely Bank of Valletta plc, Deutsche Bank (Malta) Ltd and HSBC Bank Malta plc.

The published list is still not yet finalized, with the final list to be published in September 2014. This list will be reviewed by the ECB on a regular basis.

- it introduces bail-in tools to allow authorities to write-down equity and debt and to convert debt into equity on resolution so as to recapitalize a bank. The general principle is that losses should be borne first by shareholders and next, in general, by creditors of the institution (instead of being bailed-out by taxpayers)

- it requires Member States to establish resolution funds comprised of contributions from the industry which can be used to fund aspects of resolution.

The key impacts of the BRRD on Maltese institutions may be described as follows:

- for the first time, Malta is to have a specialised resolution regime applicable to banks and large investment firms and this will represent a national legislative watershed

- investing in shares and bonds of banks may no longer be the perceived 'safe' investment it used to be in the past. Both shareholders and bondholders of Maltese banks will be exposed to bail-in procedures in the event that the bank is facing financial difficulties

- it is not entirely clear how the bail-in tools (applicable as from 1 January 2016) will impact Maltese-denominated bank bonds already in issue as at that date

- institutions will be required to meet the so-called 'MREL' – minimum requirements for own funds and eligible liabilities which are capable of being bailed-in

- producing a recovery plan and working with authorities on a resolution plan requires a considerable amount of work and resources and will mean increased compliance costs for local institutions

- banks and investment firms will need to open communication lines with a new authority, namely the resolution authority. Resolution authorities may require firms to take 'appropriate action' to ensure the removal of impediments to resolution including the power to require changes to legal or operational structures.

Single Resolution Mechanism

The BRRD is to be distinguished from the Single Resolution Mechanism ("SRM") and the Single Resolution Fund ("SRF"). In April 2014, political agreement on a regulation establishing the SRM and SRF was reached by the European Parliament, the Council and the Commission (the "Regulation"). The SRM and SRF will only apply within the Eurozone Member States and is one of the pillars of the European Banking Union, comprising centralized supervision, a centralized resolution regime including a centralized resolution fund and a centralized deposit protection scheme. The SRM and the SRF seek to ensure centralized management of the resolution of a failing bank and the Regulation has been aptly described as the institutional backbone of the BRRD within the Banking Union (i.e. within the Eurozone area rather than within the entire European Union).

The Regulation establishes a Single Resolution Board which assesses, in co-operation with national resolution authorities, the resolvability of banks of Member States participating in the Banking Union and draws up their resolution plans.

Banks within the Banking Union must contribute to the SRF. They need to make ex ante contributions to the SRF. Extraordinary ex post contributions become due if the financial means of the SRF are not sufficient to cover support measures. Of great political significance is the fact that banks in one Banking Union Member State are liable for support measures undertaken by the SRF to benefit other banks within the Banking Union, even if situated in another Member State.

As if all the above is not complex enough, it must be stated that the obligation and conditions to transfer the contributions raised at national level towards the SRF does not derive from the Regulation, but rather from an inter-governmental agreement (the "IGA") which has been signed recently between representatives of most EU Member States. Under the IGA, the SRF will be built up over eight years. Contributions raised from banks at national level will be kept in compartments corresponding to each national contracting party and these compartments will be merged gradually over an eight-year transition phase.

Concluding Thoughts

The long arm of the Banking Union is definitely taking Malta's banking sector by storm and compliance costs for banks will soar, but, nevertheless, the Banking Union is viewed by many commentators as a sine qua non in the context of a single currency. As 'The Economist' highlighted in a leading article of the 31 May 2014 issue, 'In some areas – labour-market flexibility, for instance – "less Brussels" will help growth. But not all. The euro crisis showed that the euro zone needs a banking union, which centralizes a lot of power.' As the smallest country within the Eurozone area, however, we do hope that the European Union does not necessarily always adopt a 'one size fits all' approach and that it will be sensitive to the market realities of smaller credit institutions.

EBA opinion on virtual currencies

The European Banking Authority (EBA) has published an Opinion addressed to the EU Council, European Commission and European Parliament setting out the requirements that would be needed to regulate virtual currencies. The EBA has concluded that, while there are some potential benefits from virtual currencies, the risks currently outweigh the benefits (which remain less pronounced in the EU). The Opinion is addressed in addition to national supervisory authorities and advises these authorities to discourage financial institutions from buying, holding or selling virtual currencies while no regulatory regime is in place.

The EBA has identified more than 70 risks posed by virtual currencies across several categories, including risks for users and market participants, risks related to financial integrity, such as money laundering and other financial crimes, and risks for existing payments in conventional (so-called fiat) currencies. Such risks derive from:

- the fact that a virtual currency scheme can be created – and its function subsequently changed – by anyone (including, in the case of decentralised schemes such as Bitcoins, by anyone with a sufficient share of computational power, and anonymously so)
- the ability of payers, payees and individuals who validate transactions (so-called miners) to remain anonymous;
- the inability to guarantee IT security; and
- continued uncertainty surrounding the viability of some market participants.

The EBA has concluded that a regulatory approach to address risks posed by virtual currencies would require a substantial body of regulation covering, among other things:

i. governance requirements for several market participants;
ii. the segregation of client accounts;
iii. capital requirements; and
iv. the creation of governing authorities accountable for the integrity of a particular virtual currency scheme and its key components, including its protocol and transaction ledger.

A copy of the opinion may be found **here**.

QUERIES & SUGGESTIONS

We trust that this issue of our **Banking & Financial Institutions Newsletter** was of interest to our readers, however, should you have any queries or suggestions to make, please feel free to contact **Dr Conrad Portanier** at **cportanier@ganadoadvocates.com** or **Dr Leonard Bonello** at **lbonello@ganadoadvocates.com**. We would be pleased to hear from you.

Further, should you wish to stop receiving this newsletter please click **unsubscribe** on the email sending this newsletter, or by contacting **rmizzi@ganadoadvocates.com.**

Disclaimer

This update is not intended to impart advice; readers are advised to seek confirmation of statements made herein before acting upon them. Specialist advice should always be sought on specific issues.

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