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EUROSISTEMA
CENTRAL BANK OF MALTA

FIFTH FINANCIAL STABILITY REPORT

2012

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ABBREVIATIONS

BLS	Bank Lending Survey
BR	Banking Rule
CAR	Capital adequacy ratio
CDS	Credit default swaps
CIS	Collective investment scheme
CISS	Composite indicator of systemic stress
CRD	Capital Requirements Directive
CT1	Core Tier 1
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
EFSF	European Financial Stability Facility
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
EU	European Union
GDP	Gross domestic product
GVA	Gross value added
HCI	Harmonised competitiveness indicators
ICT	Information and communications technology
IMF	International Monetary Fund
LCR	Liquidity Coverage Ratio
MFI	Monetary financial institution
MGS	Malta Government Stocks
MSE	Malta Stock Exchange
NCA	National Competent Authorities
NPL	Non-performing loan
NSO	National Statistics Office
OMT	Outright Monetary Transactions
PD	Probability of default
ROA	Return on assets
ROE	Return on equity
SSM	Single Supervisory Mechanism
UK	United Kingdom
US	United States

PREFACE

Financial stability reflects the ability of the financial system, comprising institutions, markets and infrastructures, to efficiently supply the necessary credit intermediation and payment services to the real economy to enable it to achieve sustainable growth, to be able to allocate savings into investment opportunities and to facilitate the efficient settlement of payments. Financial stability also allows the system to absorb shocks and thus manage risks that may harm its performance and, consequently, that of the economy.

The *Financial Stability Report*, hereinafter referred to as the *Report*, reviews and assesses the macro-financial conditions and developments of the financial system in Malta. It evaluates the resilience of the system and identifies sources of potential systemic risk. It also makes recommendations to preserve and, where necessary, improve the robustness of the financial system. Furthermore, the *Report* seeks to promote awareness of the workings of the financial system in Malta and of related financial stability issues.

The analysis and information contained in the main text of the *Report* is based on activities of those institutions, banks, insurance companies and investment funds which play a significant role in the economy. The main analysis in the *Report* focuses on activities of those banks classified as core domestic banks.¹ To ensure a comprehensive coverage of all systemic risk aspects, the *Report* includes an additional analysis on the rest of the financial system in a separate section. Financial soundness indicators are shown in an Appendix.

The *Report* is prepared by the Financial Stability Department of the Bank and is subsequently reviewed and endorsed by the Financial Stability Committee. The Committee is chaired by the Governor, and includes as members the Deputy Governor, the Director General, Financial Policy and Special Projects, the Director, Market Operations, the Director, Financial Stability & Information Systems, and the Advisor to the Governor.

¹ The core domestic banks are APS Bank Ltd, Banif Bank (Malta) plc, Bank of Valletta plc, HSBC Bank Malta plc, and Lombard Bank Malta plc. The list of institutions forming part of the non-core and international banks remained the same as in 2011 (refer to *Financial Stability Report 2011*).

1. OVERVIEW¹

The domestic financial sector continued to demonstrate robustness throughout 2012, while it faced challenges from an uncertain external environment characterised by fragile conditions in financial markets. However, the agreement by European Union authorities on policy actions and other measures aimed at strengthening the supervisory regime, and the timely intervention in financial markets, contributed to mitigate risks as sentiment in the international financial markets improved noticeably in the second half of the year.

Against this uncertain backdrop, the Maltese economy registered positive growth underpinned by further expansion in specific high value added sectors, such as information and communications technology, finance and tourism. The relatively buoyant domestic economy and the low rate of unemployment in Malta were important factors supporting the stability of the banking system.

The balance sheets of core domestic banks expanded by 3.5% during 2012 reflecting, to a large extent, growth in their lending portfolios, which rose by 1.8% and represented almost 60% of their assets. As in recent years, mortgage lending remained the main driver of credit activity. This rose by 6.8%, whereas corporate lending contracted by 1.1%. Customer deposits remained the banks' main source of funding, growing by 5.6% during the year. These accounted for around 82% of the aggregate balance sheet value. As a result, the loan-to-deposit ratio across core domestic banks at about 70% remained at a prudent level, well below the average ratio of euro area banks, which stood at around 110%. Wholesale funding remained minimal. Core domestic banks' exposure to fragmented markets in the euro area and possible contagion effects were substantially limited. Similarly, banks were fairly inactive in the Eurosystem weekly auctions, owing to ample levels of liquidity available in the domestic financial market.

During 2012 the risks and threats faced by the local financial sector remained broadly stable, with no new challenges emerging since the last edition of the *Financial Stability Report* and its *Update*. With respect to credit risk, the core domestic banks' exposure to specific sectors, particularly the construction and real estate sector, once more continued to pose concentration risks at a time when this sector was experiencing subdued activity. Thus, during the year the level of non-performing loans increased further, particularly in respect to lending which involved immovable property. To address these risks, in 2012 banks substantially increased their provisioning levels, whilst applying relatively high haircuts on collateral values. Meanwhile, supervisory authorities encouraged banks to continue monitoring their loan books and to periodically assess their customers' credit worthiness. Furthermore, banks were also urged to maintain haircuts at high levels on immovable property offered as collateral. With regard to their holdings of securities issued by stressed euro area countries, banks continued to dispose of such assets while increasing the holdings of higher rated sovereign securities.

Throughout 2012 core domestic banks' capital adequacy ratios remained well above the regulatory minima, standing at 14.3% for the capital adequacy ratio and at 10.3% for the Tier 1 capital ratio. Furthermore, the quality of capital remained high, underpinned by the accumulation of reserves by way of retained earnings.

In 2012 the profits of core domestic banks rose by more than a third, reflecting a steady income stream from their traditional banking business operations. The banks' liquidity risks also remained contained, owing to their reliance on stable funding sources in the form of customer deposits. Ahead of the deadline to meet regulatory requirements, in particular the Capital Requirements Directive IV, the Central Bank of Malta encouraged banks to further strengthen their capital through higher levels of retained earnings. Thus, while in general the business outlook for core domestic banks appears to be positive, a high level of profits cannot be assured given the low interest environment and the need to meet new supervisory and regulatory requirements.

Risks emanating from other components of the financial sectors' balance sheet (i.e. excluding core domestic banks) remained broadly low and unchanged. Both non-core and international banks maintained high

¹ All quoted ratios are based on weighted averages unless otherwise stated.

solvency and liquidity levels and mainly focused on transactions with non-residents. The size of international banks remained relatively high as a proportion of the total banking sector. However, linkages with the domestic economy remained minimal so that any negative systemic risks are remote. Although the non-bank financial sector was once more highly interlinked with core domestic banks, such links pose little risk to the financial sector. The performance of such institutions remained satisfactory throughout 2012.

Table 1.1
SUMMARY OF RISKS

Main vulnerabilities and risks for the financial system	Type of risk	Change in risk level since 2011 FSR	Risk position as at 2012			Risk outlook for 2013
			Moderate	Medium	Elevated	
Vulnerabilities within the financial system						
Increasing non-performing loans and the low level of provisioning	Credit	↔			●	↔
Concentration of bank lending and collateral towards property	Credit	↔			●	↔
High proportion of short-term funding	Liquidity	↔	●			↔
Subdued credit demand	Profitability	↑	●			↔
Interlinkages between bank and non-bank financial institutions	Contagion	↔	●			↔
Vulnerabilities outside the financial system						
Subdued economic conditions	Credit, Profitability	↑			●	↔
Weak activity within the construction sector and low property market turnover	Credit	↔			●	↔
Feedback loop between the public and financial sectors	Profitability	↔		●		↔
EU sovereign debt crisis	Contagion, Profitability	↓	●			↔
Government re-financing needs	Liquidity	↔	●			↔

2. THE MACRO-FINANCIAL ENVIRONMENT

Throughout 2012 the economic and financial environment remained fragile, as global growth prospects were again weak and euro area financial markets remained fragmented. Overall, the euro area economy contracted, but heterogeneity across Member States resulted in a wide divergence in key indicators. During the first half of the year, international financial markets were once more influenced by the unfolding euro area sovereign debt crisis, which increased uncertainty and continued to fragment market conditions. However, during the second half of the year, tensions in European financial markets eased considerably, underpinned by a number of complementary policy actions by the European Central Bank (ECB) and the European Commission (EC). These measures contributed to the reduction of high impact events and strengthened the supervisory regime through the creation of a single banking supervisor for the euro area, which in turn, led to a general decline in sovereign debt yields and to receding trends in systemic risk indicators.

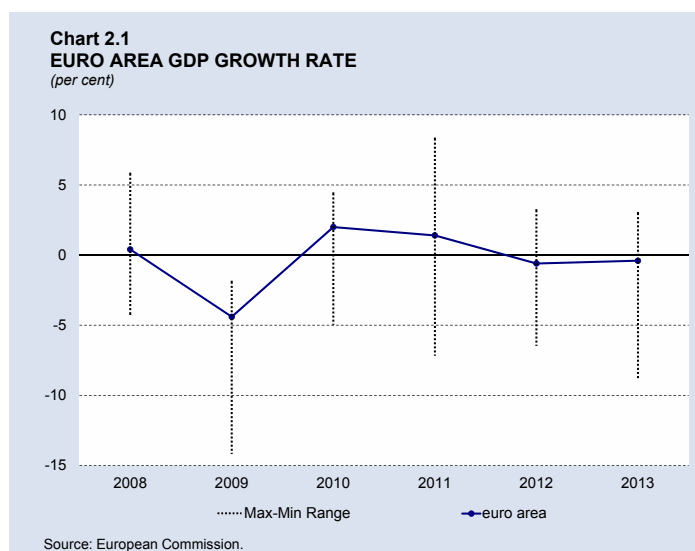
Looking ahead, in the short to medium term, a number of downside risks persist in the euro area. These emerge from several challenges, including: the need for further fiscal consolidation and structural reforms at the national level, the high level of unemployment and the prevailing tight credit conditions. In May 2013 the ECB, taking into consideration these factors and the absence of threats to price inflation in the medium term, reduced its main refinancing rate to 0.50%.

The Maltese economy remained resilient in this scenario, supported by relatively low unemployment and sustained growth in specific high value added sectors, such as information and communications technology, finance as well as tourism. However, downside risks should not be overlooked, particularly if growth in the euro area decelerates further than anticipated.

2.1 The external environment

World economic growth decelerated further, with the global gross domestic product (GDP) growing by 3.1% in real terms, down from 4.2% in 2011. The US economy grew by 1.3%, whereas economic growth in the UK stood at 0.3%. Meanwhile, the euro area economy contracted by 0.6% in 2012, falling short of the EC's forecast of -0.3%. Moreover, the euro area continued to register significant cross-country heterogeneity, with real GDP growth ranging from -6.4% to 3.2% among Member States (see Chart 2.1). A similar dispersion was evident in the labour market, with unemployment rates ranging between 4.4% and 25%, resulting in an average of 11.4% for the euro area as a whole.

Commodity prices increased further during the year, with oil prices (in US dollars) rising by 2.2%, whereas the price of gold went up by 7.1%. Moreover, pressures in the equity market appeared to have abated, particularly during the second half of 2012, with the DJ STOXX Europe 600 Index recovering by 14.4%, although remaining significantly below pre-crisis levels¹. The banking component of the index recorded a larger



¹ The DJ STOXX Europe 600 index is derived from the STOXX Europe total market index and is a subset of the STOXX Global 1800 index. With a fixed number of 600 components, the STOXX Europe 600 index represents large, mid- and small capitalisation companies across 18 countries in Europe.

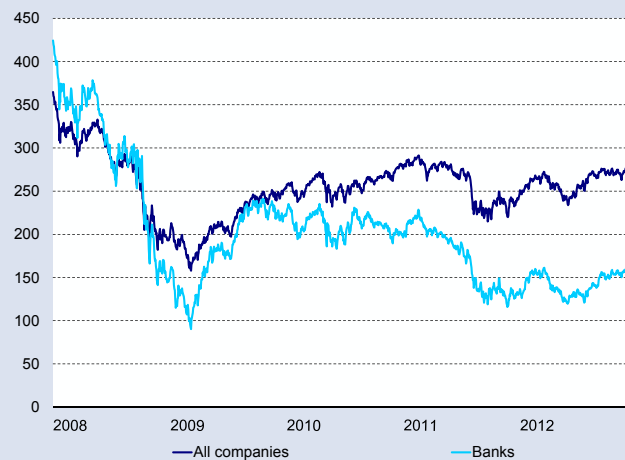
improvement, rising by 23.1% (see Chart 2.2). Meanwhile, standard volatility benchmarks also declined, reaching the lowest levels since the outbreak of the sovereign debt crisis in 2007 (see Chart 2.3).²

Tensions in the euro area sovereign debt market continued throughout 2012. Heightened risk aversion, particularly in the first half of the year, contributed to a widening of the divergence in government bond yields (see Chart 2.4). However, during the latter half of 2012, financial conditions improved, with risks to financial stability abating following various policy responses by authorities. These led to a general drop in sovereign bond yields and to a decline in sovereign credit default swaps (CDS) from their peak levels. Furthermore, the risk of joint sovereign defaults (represented by co-movements in the sovereign CDS) also declined, aided by the ECB's non-standard measures and by the adjustment programmes undertaken by highly indebted countries.

This improvement was reflected in several systemic risk indicators, including the Composite Indicator of Systemic Stress, which fell steadily during the year, although remaining slightly above pre-crisis levels (see Chart 2.5).³ Nevertheless, in early 2013, challenges across the euro area re-surfaced, with Cyprus being the fifth country to request a European Union/International Monetary Fund (EU/IMF) programme. Contagion to other euro area markets was largely contained as the exposure of euro area banks to Cyprus was limited, with the exception of Greece, where the operations of Cypriot banks located in Greece were ring-fenced.

During the year credit standards in the euro area remained rather tight,

Chart 2.2
DJ STOXX 600 (EUROPE)



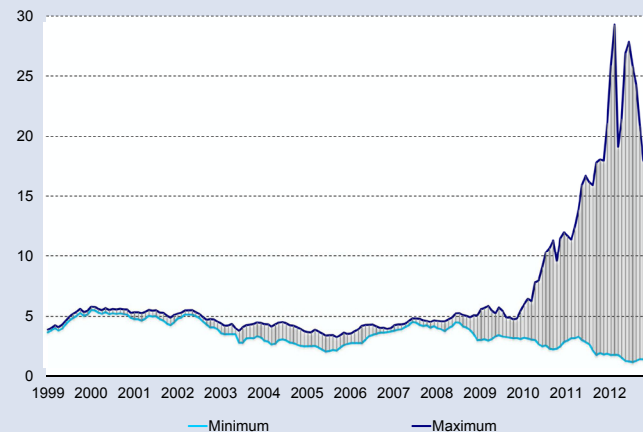
Source: Reuters.

Chart 2.3
VOLATILITY INDEX - VDAX



Source: Reuters.

Chart 2.4
DISPERSION OF EURO AREA TEN-YEAR SOVEREIGN BOND YIELDS
(per cent)



Source: Reuters.

² VDAX is a measure of the implied volatility of the DAX, which is a blue chip stock market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

³ The CISS is an indicator composed of 15 financial stress measures split equally in five categories, including the financial intermediaries sector, money markets, equity markets, bond markets and foreign exchange markets.

constraining credit supply. Bank profitability was on the low side, partly affected by banks' asset quality. The latter persisted as a key concern in view of weak economic activity, together with declining property prices in several Member States.

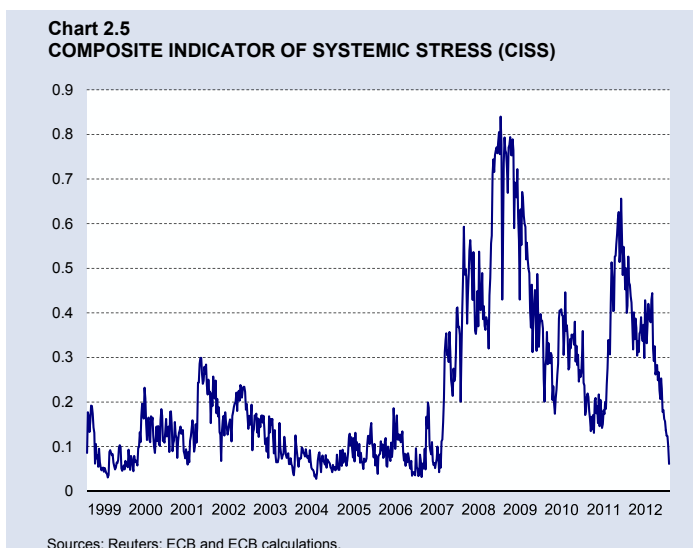
Throughout 2012 the ECB and EU Member States took various steps to manage and mitigate risks arising from the sovereign debt crisis and from the negative feedback loops to the banking sector. Apart from further lowering its key policy interest rate, the ECB implemented a number of additional non-standard measures. In September it launched the Outright Monetary Transactions,

involving the purchase of sovereign bonds in secondary markets by the ECB. This measure was aimed at repairing the monetary transmission mechanism in dysfunctional financial markets, particularly those in stressed euro area countries.⁴ Furthermore, in order to continue supporting liquidity, the ECB widened the eligibility criteria for collateral and extended the list of eligible marketable debt instruments for the Eurosystem's monetary operations. In September 2012 the EC proposed a single supervisory mechanism (SSM) for European banks. This is the initial step towards an integrated banking union with the ultimate objective of stabilising the financial system. Other objectives of the banking union are a break in the link between banks and sovereigns and a reduction in financial market fragmentation. In December the Economic and Financial Affairs Council (ECOFIN) reached an agreement on the SSM, giving the ECB banking supervisory powers over all credit institutions in the euro area and in other participating non-euro area Member States (see Box 1). While the SSM is expected to restore confidence in the euro area banking sector, it is envisaged that it will eventually be complemented with a single resolution mechanism and a common deposit insurance fund.

Towards the end of 2012, the euro area finance ministers and the IMF reached an agreement to reduce Greek debt, at which point European authorities released more than €34 billion in bail-out funds (€23.8 billion to banks and €10.6 billion in budget assistance). An additional €9.3 billion was to be paid in three tranches by the IMF. Through these measures, Greece completed a debt buyback to reduce its outstanding debt level. On completion, Standard and Poor's upgraded Greece's credit rating to B-.⁵ Until 5 July 2013, European authorities had disbursed more than €130 billion in bail-out funds.

In June 2012 Spain requested a facility from the EU to finance the recapitalisation of banks, following large losses incurred on the collapse of the real estate market. This assistance was provided by the European Financial Stability Fund (EFSF) in the form of loans with an agreed maximum of €100 billion. By the end of 2012, around €40 billion were injected into four Spanish banks. During 2012 Spain was downgraded gradually from AA- as at end-2011 to BBB- in October 2012 by Standard and Poor's.

In the first half of 2011, Portugal requested an EU/IMF programme amounting to €78 billion, which should run until June 2014. Since then several measures have been undertaken by the Portuguese Government to restore sustainability in public finances. By end-2012, Portugal regained access to financial markets following a successful bond exchange plan. During late 2012 and early 2013, the Portuguese Government injected almost €7 billion to recapitalise three banks.



⁴ Stressed countries include Cyprus, Greece, Italy, Ireland, Portugal and Spain.

⁵ Following the announcement by Greece of its intention to conduct a bond buyback, S&P downgraded Greece to Selective Default from CCC. This downgrade was reversed shortly after the completion of the programme, with the new B- rating being the strongest rating since June 2011.

Throughout 2013 the euro area economy is expected to contract by 0.4%, considerably below previous estimates which had forecast a growth rate of 1%. Labour market conditions are projected to deteriorate, with the unemployment rate reaching 12.2% in 2013.⁶ Cross-country heterogeneity is expected to persist, with problems in stressed countries continuing to place constraints on the overall recovery of the euro area.

BOX 1: SINGLE SUPERVISORY MECHANISM

The process towards a banking union

At the euro area summit of 29 June 2012, the Heads of State or Government decided to establish a single banking supervisory mechanism run by the ECB, following which the European Stability Mechanism (ESM) would be enabled to inject funds directly into distressed banks.¹ On 12 September 2012, the EC adopted a package of proposals to set up a SSM for banks.

The proposed package is set on three pillars:

- (i) a legislative proposal for a Council Regulation to assign specific tasks to the ECB;
- (ii) a legislative proposal for a regulation designed to align the existing European Banking Authority (EBA) Regulation to the modified framework for banking supervision;
- (iii) a communication on a roadmap for completing a banking union (which would incorporate a SSM, a Single Resolution Mechanism and a Single Deposit Insurance Mechanism).

Agreement on these three pillars was reached by EU finance ministers at a special ECOFIN meeting on 12-13 December 2012.² This process is expected to break the negative feedback loop between governments and banks, and to restore confidence in the soundness of the banking system.

This box explains the main features of the proposed SSM, lists the tasks of the ECB and the national competent authorities (NCA) within this framework, and broadly describes the benefits of the SSM.

Role of the ECB within the SSM

In line with Article 127(6) of the Treaty of the Functioning of the European Union, the proposed regulation confers on the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions. The objective of the regulation is to contribute to the safety and soundness of credit institutions, and to the stability of the financial system within the EU and in each Member State. Besides the ECB, the SSM will involve NCAs in the supervision of banks established in Member States participating in the Mechanism. The ECB shall be responsible for the overall effective functioning of the SSM and shall assume all the tasks conferred on it by the proposed Regulation 12 months after its entry into force. The NCAs shall assist the ECB, including in the on-going day-to-day assessment of a bank's situation and related on-site verifications. The ECB shall cooperate closely with the EFSF and with relevant resolution authorities and other mechanisms providing direct or indirect public financial assistance.

¹ http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf

² <http://register.consilium.europa.eu/pdf/en/12/st17/st17812.en12.pdf>

⁶ Source: European Economic Forecast Spring 2012, European Economic Forecast Winter 2013.

The SSM framework shall cover all credit institutions established in euro area countries and in other EU participating Member States (estimated at more than 6,000 banks).³ The ECB shall carry out direct supervision, in conjunction with NCAs, of those banks that are deemed significant, specifically around 130 banks.⁴ Less significant banks shall continue to be supervised by NCAs, which shall abide by ECB regulations, guidelines or general instruction. The ECB shall have access to data concerning all credit institutions and may opt to exercise direct supervisory powers on any credit institution, either on its own initiative or upon request by NCAs.

The ECB shall conduct on-site supervision of significant banks through the deployment of joint teams with respective competent authorities, whilst off-site supervision shall be carried out through the assessment of key indicators for the entire banking system. As set out in Article 5(4) of the regulation, a bank is deemed to be significant if:

- (i) the total value of its assets exceeds €30 billion; or
- (ii) the ratio of total assets to GDP of the participating Member State of establishment exceeds 20%, unless the total value of assets is below €5 billion; or
- (iii) following a notification by the NCA to consider an institution of significant relevance in the domestic economy, the ECB takes a decision confirming such significance following its own comprehensive review, including a balance sheet assessment.

The ECB may also, on its own initiative, consider an institution to be of significant relevance when it has established banking subsidiaries in more than one participating Member State and its cross-border assets or liabilities represent a significant part of its total assets or liabilities. Those banks for which public financial assistance has been requested or received directly from the EFSF or the ESM shall be automatically considered as significant. As a minimum, the ECB shall carry out the tasks conferred on it by this regulation for the three most significant credit institutions in each of the participating Member State, unless justified by particular circumstances. Branches in EU countries not part of the SSM but originating from participating Member States are subject to supervision by the SSM.

Supervisory tasks of the ECB

The following are the tasks conferred on the ECB by the proposed regulation:

- (i) to authorise and to withdraw authorisation of credit institutions;
- (ii) to assess applications for the acquisition and disposal of qualifying holdings in credit institutions;
- (iii) to ensure compliance with prudential requirements on credit institutions in the areas of own funds requirements, securitisation, large exposure limits, liquidity, leverage, and reporting and public disclosure of information on those matters;
- (iv) to ensure compliance with Union acts requiring credit institutions to have in place robust governance arrangements;
- (v) to carry out supervisory reviews, including stress tests and their possible publication;
- (vi) to carry out supervision on a consolidated basis of credit institutions' parents established in one of the participating Member States;
- (vii) to participate in supplementary supervision of a financial conglomerate;
- (viii) to carry out supervisory tasks in relation to recovery plans and early intervention.

With regard to macro-prudential policy, the ECB shall also be empowered to apply higher requirements for capital buffers and other prudential measures specifically set out in relevant Union law, if

³ The regulation allows non-euro area EU Member States to participate through the setting up of close cooperation.

⁴ In Article 5, paragraph 4, significant relevance is determined according to size, importance for the economy and cross-border activities.

deemed necessary to address systemic or macro-prudential risks.⁵ Tasks not listed in the regulation shall be carried out by NCAs.

To carry out the tasks listed above, the ECB has been allocated an array of powers, which include investigatory powers, authorisation, supervisory powers and sanctioning. To avoid conflict of interest between supervision and monetary policy, the proposed regulation establishes a supervisory board to carry out preparatory work and propose to the Governing Council of the ECB draft decisions for its adoption. Unless an objection is made by the Governing Council within a period not exceeding a maximum of ten working days, a draft decision will be deemed adopted. To support its activities, a steering committee will be appointed by the Supervisory Board.

The proposed regulation requires the ECB to be accountable to the European Parliament and to the European Council. The ECB shall submit each year to the European Parliament, the Council, the Commission, the Eurogroup and the national parliaments of participating Member States, a report on the execution of the tasks.

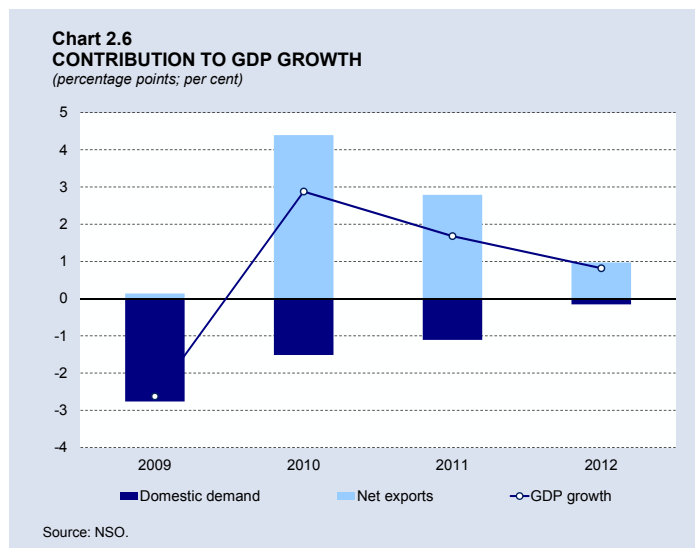
Benefits of the SSM

The SSM offers a number of benefits. First, the ESM can provide direct recapitalisation to troubled banks under a uniform framework, thus addressing the issue of the feedback loop between sovereigns and banks. Second, the SSM is expected to enhance banking supervision, thus facilitating a more effective identification and mitigation of risks. Third, the SSM will contribute to the harmonisation of supervisory practices across Member States, thus limiting regulatory arbitrage and ensuring greater transparency and comparability. Fourth, the ECB shall have access to supervisory skills and expertise from all participating Member States. Finally, the SSM is expected to contribute significantly in reversing fragmentation within the financial market and to restore confidence in the banking sector.

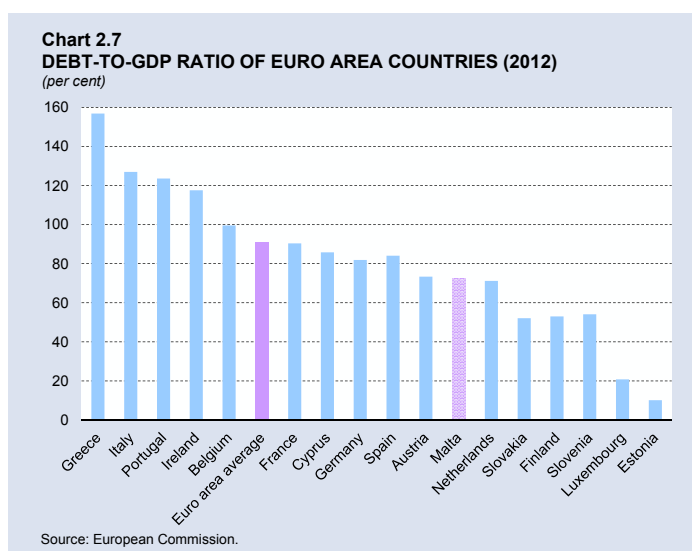
⁵ Article 4a of the Proposal for a Council Regulation conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions (Regulation EU No. 17812/12).

2.2 The domestic environment

During 2012 Malta's economic activity remained generally resilient, outperforming the euro area. Economic growth in 2012 was at 0.8%, lower than the 1.7% registered in 2011. This slowdown was largely driven by a decline in domestic demand, primarily contractions in both gross capital formation and household consumption. On the other hand, government consumption expenditure increased during the year, while net exports contributed positively to GDP growth adding just under 1 percentage point (see Chart 2.6). At 5.2%, exports grew at a faster pace than imports, which rose by 4.4% during 2012.



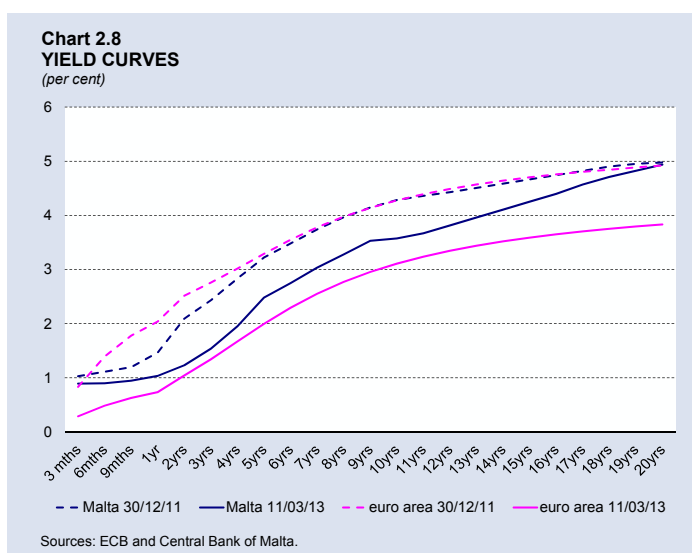
As observed in the last few years, some economic sectors continued to register rapid growth, while others lagged behind. Activity within the construction sector remained subdued, decelerating further over the previous year. Lower investment by the private sector in construction may imply some containment of supply conditions in the real estate market. According to the Real Estate Market Survey of the Central Bank of Malta, demand for real estate remained subdued. During the year, the Bank's advertised residential property price index registered an average marginal increase of 0.5% and is projected to rise further by 1.8% in 2013.



In 2012 the public debt-to-GDP ratio increased to 72.1% from 70.3% a year earlier, while the deficit stood at 3.3% of GDP. Although exceeding the 60% benchmark set by the Maastricht criteria, the public debt-to-GDP ratio remains lower than the euro area average (see Chart 2.7).

Malta's sovereign debt credit rating was downgraded by two credit rating agencies but was kept unchanged by another rating agency.⁷ On the other hand, the yield curve for Malta government securities shifted downwards compared with 2011 (see Chart 2.8). Meanwhile, the spread on the ten-year government bond vis-à-vis the German bund narrowed. Strong demand continued for domestic sovereign debt, which is mostly held by residents, and benefitted from the domestic economy's resilience to international turmoil.

In terms of external competitiveness, Malta's Harmonised Competitiveness Indicators (HCI) based on consumer price indices declined by 0.6% over the previous year, a lower extent than the drop of the euro area average, which fell by 2.3% annually.⁸ The unit labour cost index for Malta continued to rise, up by 3.7% during 2012, a faster rate than in the euro area where the index rose by 1.5%. In 2012 the country's current account turned into a surplus of €24.2 million, compared with an average deficit of €266.5 million in the previous



⁷ In February 2012 Moody's adjusted the ratings of nine European sovereigns, including Malta, to capture downside risks. As a result, Malta's government bond rating was downgraded to A3 from A2, with the outlook remaining negative. Standard and Poor's lowered Malta's credit rating a notch to A- in January 2012 and then to BBB+ in January 2013, also with a stable outlook. Fitch kept its credit rating stable at A+.

⁸ The HCI produced by the ECB provides a comparable measure of euro area countries' price and cost competitiveness that are also consistent with the real effective exchange rates of the euro.

five years. The unemployment rate increased slightly to 6.5% by end-2012, remaining amongst the lowest across euro area countries (see Chart 2.9).

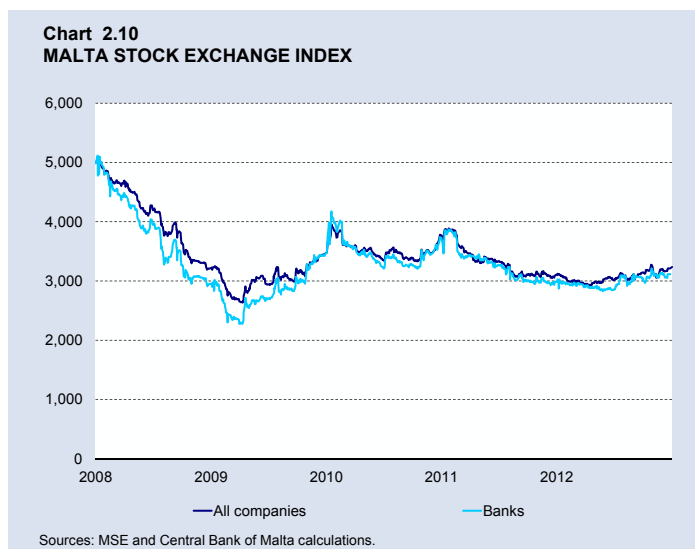
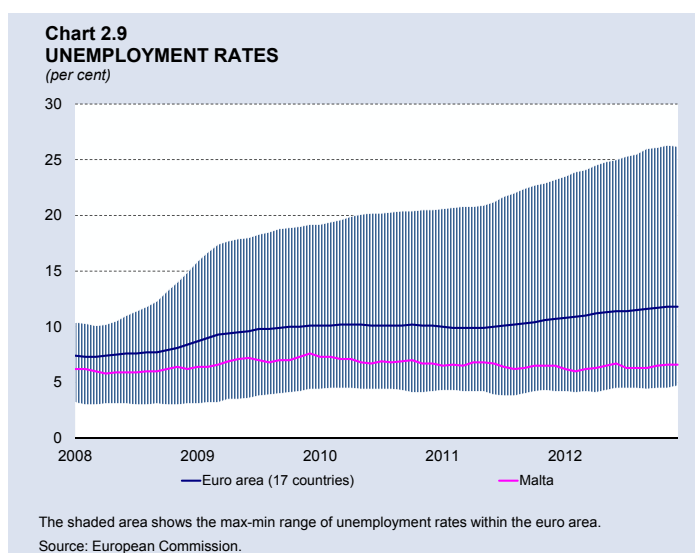
Meanwhile, the financial sector, in particular the banking sector, supported financial stability with a positive flow of credit supply, despite tight credit standards. The domestic banks' business model together with their limited exposure to stressed countries enabled banks to maintain their already high profitability levels. Furthermore, such profits continued to support the build-up of capital buffers.

The financial infrastructure provided further effective support to the domestic economy. Throughout the year, payment and securities settlement systems maintained a high level of efficiency, ensuring a smooth transfer of funds and clearance of securities.

Meanwhile, the Malta Stock Exchange Index rose by 3.8%, mirroring the higher share prices of listed banks, which constitute the bulk of stock market capitalisation (see Chart 2.10).

In early 2013, the EC's consumer and industry confidence indicators for Malta showed signs of further improvement, despite remaining negative throughout 2012. These trends contrast with the euro area average, which worsened during 2012.

Looking ahead, the Maltese economy is projected by the Central Bank of Malta to grow by 1.4% in 2013, with a subdued outlook, given the slowdown in the world economic growth and the negative outlook in the European Union. The inflation rate based on the Harmonised Index of Consumer Prices is anticipated to decline to 1.4% in 2013, and is expected to drop further in the forthcoming years. The unemployment rate is forecast to remain stable at 6.5% in 2013.



3. FINANCIAL STABILITY CONDITIONS

During 2012 risks faced by the financial sector remained broadly unchanged from those identified a year earlier. Modest economic growth, as well as slack conditions in the construction and real estate sectors contributed to an increase in credit risk, although this was partially addressed by a higher level of provisions by banks. In contrast, sovereign risk remained insignificant, owing to banks' limited holdings of debt issued by countries undergoing an adjustment programme. Meanwhile, liquidity remained ample, particularly as the flow of resident deposits was positive, supporting banks' operations.

3.1 Credit risk

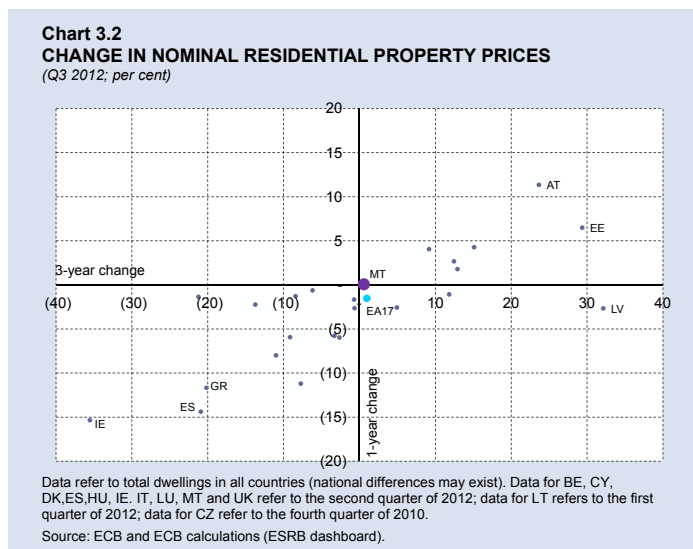
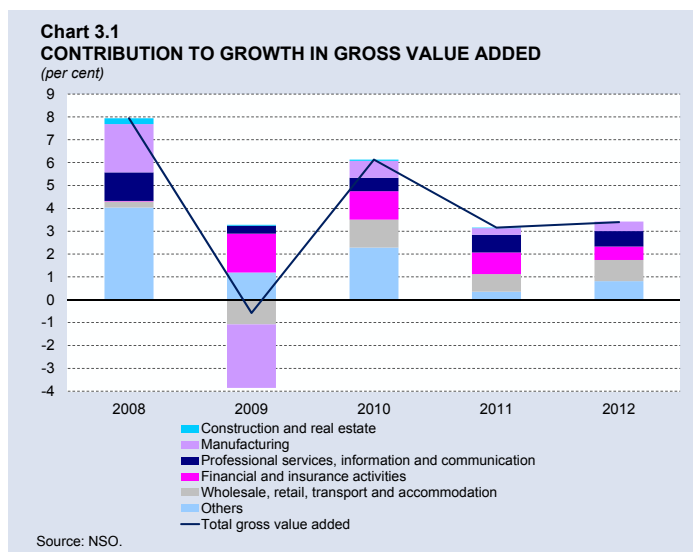
In 2012 credit risk increased marginally from 2011. In light of continued weaknesses in certain sectors of the economy, the level of non-performing loans (NPL) in the corporate sector edged up. Credit risk from the household sector, however, remained low, supported by high employment levels and further accumulation of financial wealth.

3.1.1 The corporate sector

The performance of non-financial corporations in aggregate improved during 2012, with their operating surplus increasing by 3.8% year-on-year. However, at a sectoral level, results were mixed. Some corporations, particularly those involved in financial services, ICT, gaming and the high value added industries operating in the manufacturing sector, maintained their momentum. On the other hand, the performance of enterprises within the construction sector continued to be affected negatively by the weak local property market. Chart 3.1 illustrates the varying contributions of economic sectors to gross domestic product (GDP) growth.

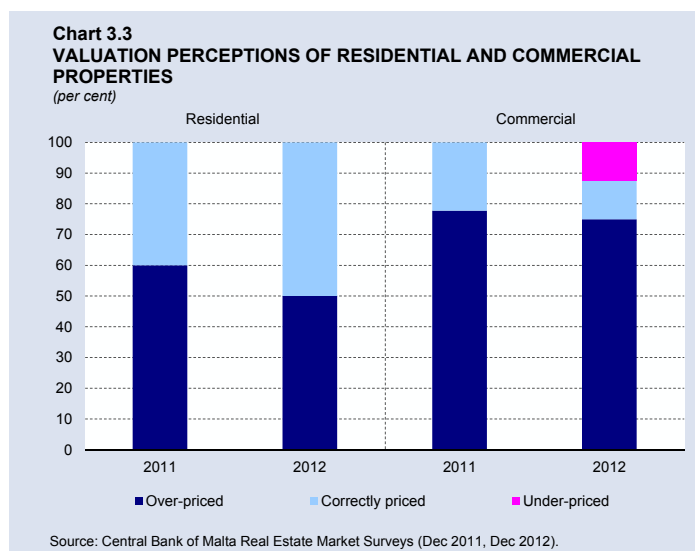
Construction and real estate

Despite the slowdown in business activities, the performance of both the construction and real estate sectors was positive during 2012. The operating surplus of the construction sector rose by 4.5% over the previous year, whilst that of the real estate sector went up by 4.9%.¹ However, these sectors' contribution to gross value added (GVA) was negligible since compensation of employees, the other



¹ Source: NSO.

major component of GVA, declined by 2.1%. At the same time, indicative property prices as calculated by the Central Bank of Malta's Advertised Property Price Index increased slightly during the year, up by an average of 0.5% in 2012. The generally stable situation in the Maltese property market contrasted sharply with continuous depressed conditions in real estate markets in several euro area countries, notably Ireland, Spain and Greece (see Chart 3.2). The rise in domestic property prices was, however, not sufficient to offset the downward movement in prices that occurred in recent years, particularly in 2008 and 2009.



Despite stable property prices and the positive performance of the sector, the Real Estate Market Survey conducted by the Bank revealed that during 2012 the volume of property sales, both for residential and commercial purposes, declined. Property prices are still perceived to be somewhat overpriced for both categories, despite some improvement in expectations, particularly in the commercial property market (see Chart 3.3). In addition, the Construction Confidence Index for Malta (published by the European Commission) remained in negative territory throughout 2012, as did the indices of other euro area countries.

The number of units for which permits were issued by the Malta Environment and Planning Authority declined by around 22% in 2012, when compared with the same period a year earlier. The slowdown in the issue of such permits may reflect the oversupply of property in the real estate market. This may continue to persist, in view of slower growth in mortgage credit and the uncertain economic outlook overseas, which has a negative impact on foreign demand at the high end of the market. On the positive side is the government's re-launch of a revised permanent residence scheme in June 2013, with the objective of attracting more foreigners to buy property in Malta.

The generally subdued sentiment in the Maltese property market induced banks to maintain their cautious approach when lending to the construction and real estate sectors. The exposure to the construction sector accounted for 21.5% of corporate loans, while lending to the real estate sector amounted to around 8%.

Other non-financial corporate sectors

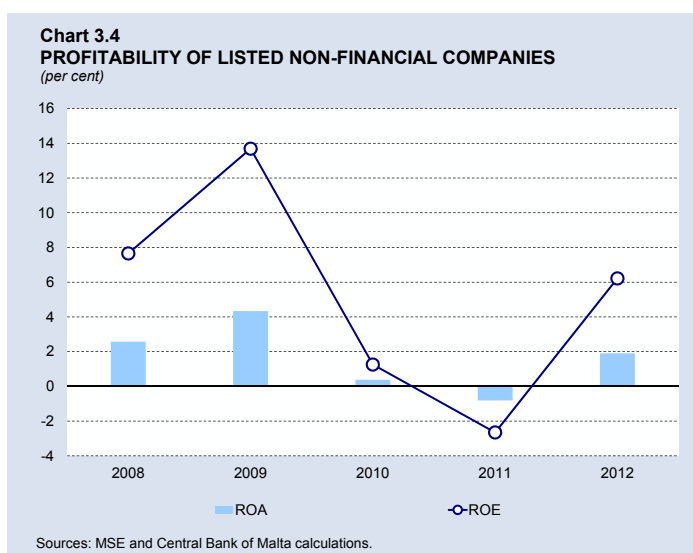
The performance across the rest of the corporate sector varied. Overall, the weaknesses of specific sectors were compensated by improved results in others. Firms involved in transportation recorded a drop in their activity, while those engaged in manufacturing, wholesale & retail and accommodation registered an improvement. The 2.1% increase in the operating surplus of the manufacturing industry was supported by the expansion in output, as reflected in the Index of Industrial Production, which rose by 10.2% in 2012.² With regard to accommodation activities, results from the Malta Hotels and Restaurant Association Survey indicated that in 2012 the gross operating profit increased, despite higher overheads faced by the industry. This improvement was recorded among the three, four and five-star hotel categories, mainly driven by higher turnover levels as tourism remained buoyant.

² The Index of Industrial Production, which is compiled by the National Statistics Office, describes the economic cycles of the manufacturing industry.

Listed non-financial companies

Compared with 2011, the performance of business groups, which acquired funding from the domestic capital market, improved during 2012.³ The overall return on equity and return on assets turned positive, estimated at 6.2% and 1.9%, respectively (see Chart 3.4).⁴

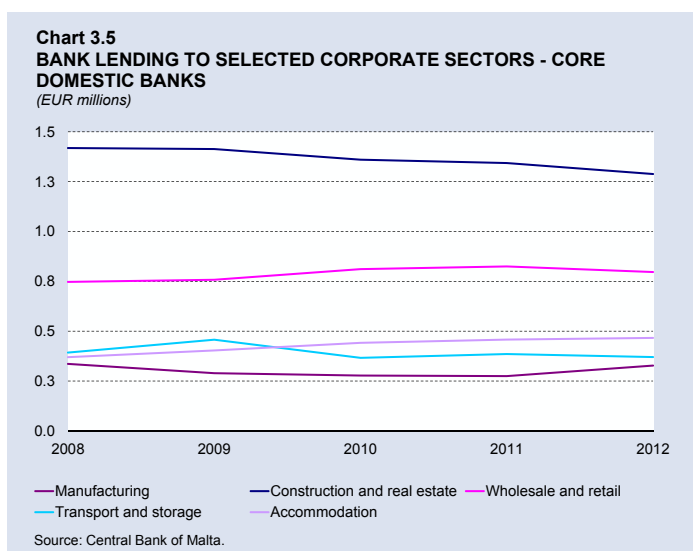
The overall sales of listed companies increased by 2% in 2012 compared with a 10.2% rise a year earlier. This increase was registered in different sectors. At the same time, the ratio of current assets to current liabilities stood at 123.1%, suggesting a sound liquidity position, although this was lower by 17 percentage points on a year earlier. This fall was partly the result of a number of early bond redemptions, some of which were financed by internal funds. Meanwhile, the proportional increase in capital and reserves and total assets kept the leverage ratio broadly stable at 41.2%.



Corporate indebtedness and concentration

During 2012 lending by core domestic banks to the resident corporate sector decelerated further, contracting by 1.1% as investment activity in the domestic economy remained subdued.⁵ Results of the Bank Lending Survey show that this slowdown was primarily demand driven, although the banks remained risk averse. Indeed, core banks maintained tight credit standards, both in respect of small and medium-sized companies and of large corporates, particularly in relation to companies involved in the property market (refer to Box 2). The contraction in corporate credit was mainly accounted for by the construction sector. Lending to the wholesale, retail and transport sectors also declined, whilst credit to the manufacturing and accommodation sectors somewhat increased (see Chart 3.5). Meanwhile, at 5.3%, the weighted average interest rate on lending to the resident corporate sector remained in line with 2011.

External funding through the capital market by the resident corporate sector also fell, with the value



³ This group includes those companies which have issued bonds or shares on the Malta Stock Exchange.

⁴ Since the full year results for some companies were not yet available, the estimates for 2011 were calculated using tailored annualisation methods: in the case of firms whose performances are seasonal, the mid-year growth rates were replicated in the second half of the firms' fiscal year, while for the rest, the second half was assumed to be identical to the first half. The performance for each specific year reflects the year in which the final accounts are published, irrespective of the month.

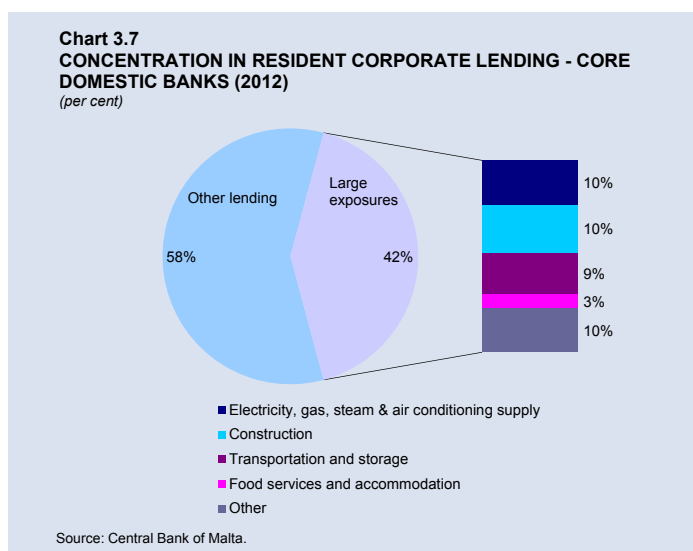
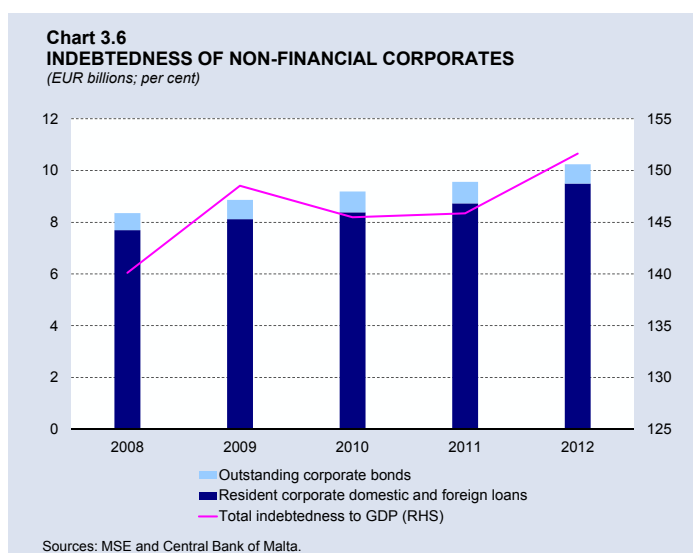
⁵ A similar pattern was observed in the total banking system, which registered a drop of 1.3% during 2012.

of quoted and unquoted bonds declining by 10.4% in 2012 compared with a year earlier. With regard to bonds issued on the Malta Stock Exchange, two corporations operating in the hotel industry launched new bonds totalling €27.5 million during the year. The new issues were, however, more than offset by redemptions and buy-backs by other companies mainly operating in the construction sector.

However, overall corporate indebtedness (which includes bonds, bank credit and funding from non-financial and other stakeholders) increased to 151.6% of GDP in 2012 from 145.9% in 2011 (see Chart 3.6). When considering outstanding quoted bonds and loans granted to the corporate sector by core domestic banks, corporate indebtedness dropped to 73% of GDP compared with 76.3% a year earlier. Loans granted by non-core domestic banks to the resident corporate sector amounted to 3.3% of GDP, while lending by international banks to the resident corporate sector was negligible.

The sectoral allocation of loans remained generally stable, with some concentration resulting from bank credit being extended to a number of large borrowers operating within specific industries.⁶

These borrowers, which include firms in construction, transport and the energy-related sectors, accounted for over 40% of total corporate credit (see Chart 3.7).



⁶ A loan is classified as a "large exposure" when it accounts for more 10% of Tier 1 capital of a particular bank.

BOX 2: BANK LENDING SURVEY RESULTS

Credit Supply Conditions

Results of the Bank Lending Survey (BLS) show that banks have tightened their credit standards on corporate loans during the first quarter of 2012 while maintaining them unchanged throughout the rest of the year (see Chart 1).¹

The tightening stance was prompted by adverse perceptions on the general economy and specifically the outlook on the construction sector, as well as subdued property prices. It was transmitted through stricter controls on the size of loans, collateral requirements and loan repayment periods.

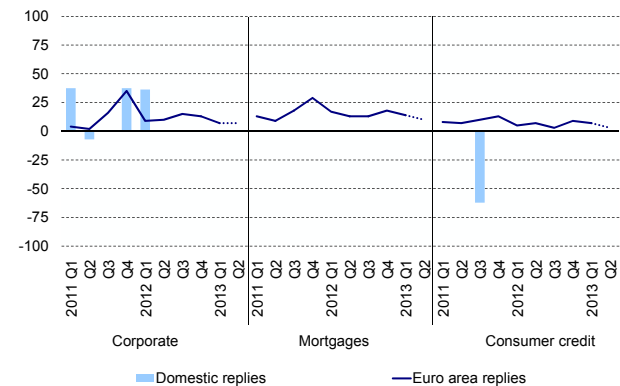
In contrast with the euro area, credit standards in Malta were kept unchanged during the last three quarters of 2012. Negative economic and industry-specific perceptions led some banks to tighten their credit standards on all three loan categories (corporate, mortgage and consumer credit), but the impact of this tightening was offset by some easing of controls by certain banks as they faced competitive pressures from others. During the first quarter of 2013, credit standards were maintained stable across the three loan categories and no changes are anticipated for the second quarter of the year.

Credit Demand Conditions

During 2012 credit demand in Malta remained generally subdued (see Chart 2).

**Chart 1
CREDIT STANDARDS**

(+ indicates net tightening / - indicates net easing)

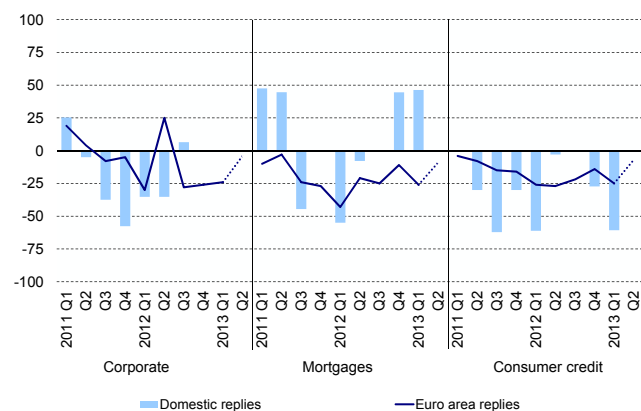


Note: 2013 Q2 information relate to expectations. Domestic mortgage and consumer credit standards were unchanged.

Sources: ECB and Central Bank of Malta calculations.

**Chart 2
CREDIT DEMAND**

(+ indicates increase / - indicates decrease)



Sources: ECB and Central Bank of Malta calculations.

¹ The BLS is the Central Bank of Malta's contribution to the European Central Bank's euro area BLS. This quarterly survey in which all euro area national central banks participate is designed to provide qualitative data on bank lending behaviour in the euro area. Participating banks are asked to express their views on developments in credit conditions in the previous quarter and their expectations for the subsequent quarter. Four of the five core domestic banks in Malta participate in this survey.

In the first half of 2012, corporate credit demand declined, but stabilised towards the end of the year. This development reflected lower fixed investment, inventories and working capital. Higher competitive pressures from banks which do not participate in the BLS also contributed to the fall in credit demand of participating banks. On the other hand, lending in response to debt restructuring needs partly offset this decline. During the first quarter of 2013, corporate credit demand remained unchanged, with no changes being anticipated for the second quarter of the year.

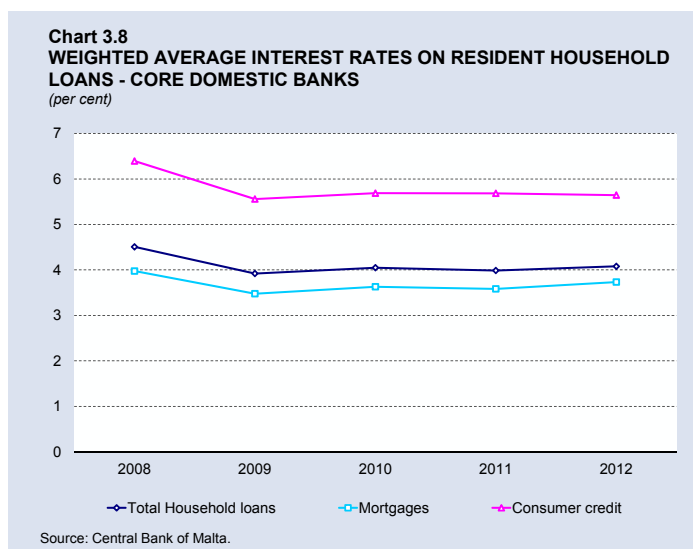
In the case of mortgages, respondents reported lower demand during the early months of 2012, as competitive pressures, subdued housing market prospects and deteriorating consumer confidence had a negative impact on the mortgage credit market. However, a slight improvement in housing market prospects towards the end of the year led to higher demand. Meanwhile, demand for consumer credit, which is considered as sensitive to households' perceptions on economic conditions, remained sluggish throughout the year. Lower spending on durable goods, drops in consumer confidence and competitive pressures were downside factors affecting such demand. In the first quarter of 2013, banks reported some improvement in demand for home loans, whereas in the case of consumer credit, demand dropped further. Respondent banks expect demand to remain stable for both loan categories during the second quarter of 2013.

3.1.2 The household sector

Household indebtedness

During 2012 the growth rate of households' resident loans stood at 5.2%, down from 7% a year earlier. The deceleration in household credit growth was consistent with the slowdown in economic activity, particularly private consumption, which remained subdued. Thus, consumer credit, which is more responsive to economic developments, contracted by 1.2%. However, mortgage lending remained buoyant, growing by 6.8% in 2012. Viewed over the longer-term horizon, such growth rates are noticeably lower than their five-year averages, with consumer credit and mortgage lending averaging 7.9% and 10.3%, respectively. Since household borrowing grew at a faster pace than GDP, the household debt-to-GDP ratio rose by 1 percentage point to 55.7% by end-2012. Household indebtedness, however, remained lower than the average for the euro area, which stood at 66%.⁷

The cost of borrowing for households increased marginally, with the weighted average interest rate on household loans standing at 4.1% by end-2012. The average interest rate of mortgage loans edged up to 3.7%, while that for consumer credit was almost unchanged at 5.6% (see Chart 3.8).⁸ With household outstanding debt rising in 2012, the interest burden remained



⁷ Refer to ECB *Financial Stability Report, May 2013*.

⁸ The weighted average interest rate on consumer credit also includes credit card debt. However, since the latter is equivalent to just around 14% of total consumer credit, the impact on the overall weighted average interest rate is limited.

relatively low and stable at around 5% of household income, as the latter was boosted by a rise in compensation of employees.

The credit worthiness of resident households was also supported by an increase in their net financial wealth, which rose by 6.4% in 2012, significantly higher than the 0.1% growth rate reported a year earlier. This improvement reflected higher holdings of deposits and other financial assets, particularly domestic quoted securities (see Chart 3.9).

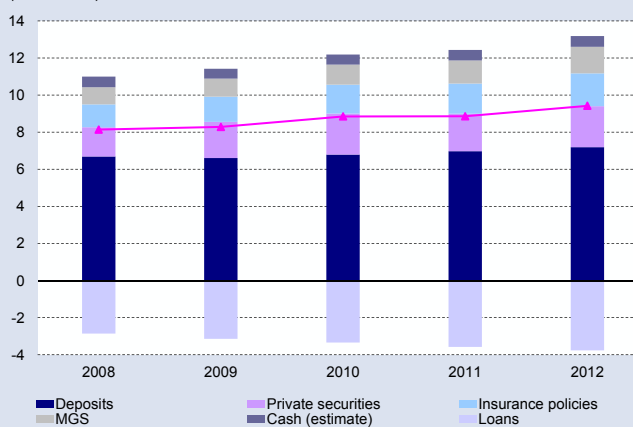
The distribution of household loans by income bracket implies a low level of credit risk for banks. During 2012 around 46% of bank loans was channelled to households with an annual income exceeding €30,000 per annum, whereas loans granted to households with an income of less than €10,000 per annum remained low, at just 3.7% of the total (see Chart 3.10).

3.1.3 Quality of bank loans

At the end of 2012 the NPL ratio of core banks was 8.1%, up from 7.3% in 2011 (see Chart 3.11). The increase was mainly attributable to the corporate sector. However, around a third of this increase was underpinned by better statistical classification across the loan performance categories. Almost all NPLs pertained to residents, with the share of non-residents in the total standing at less than 1%.

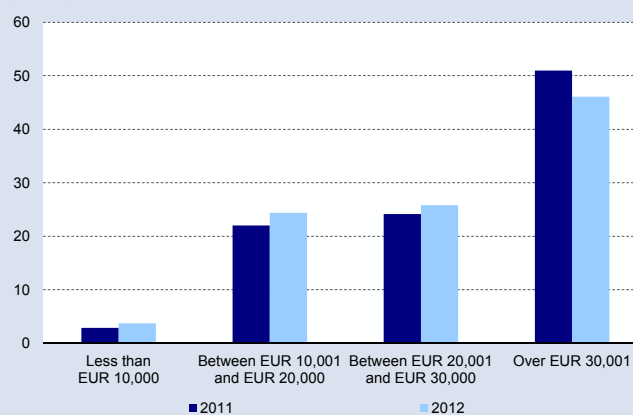
Resident corporate NPLs as a proportion of total corporate lending increased to 12.7% by end-2012 from 11.1% in 2011. This reflected a rise in corporate NPLs and a slight contraction in the level of overall corporate lending, which both contributed to the deterioration in the NPL ratio. Higher NPLs were

Chart 3.9
NET HOUSEHOLD FINANCIAL WEALTH
(EUR billions)



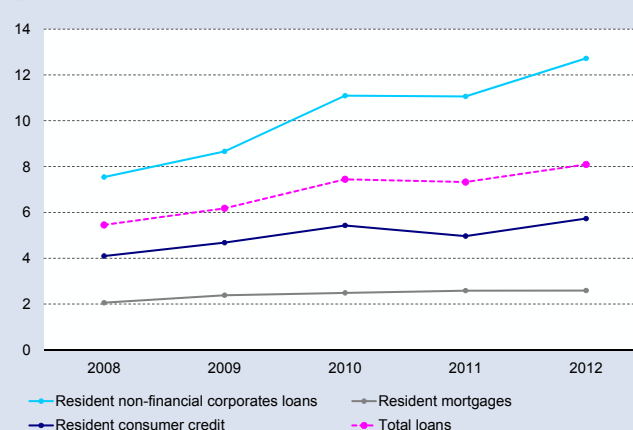
Sources: MSE and Central Bank of Malta.

Chart 3.10
DISTRIBUTION OF HOUSEHOLD LOANS BACKED BY RESIDENTIAL PROPERTY BY INCOME BRACKET - CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

Chart 3.11
NPL RATIOS - CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

reported by most core domestic banks and were spread across all main economic sectors, particularly the construction & real estate sector (see Chart 3.12). The elevated level of NPLs in this sector remains a source of risk to the banking sector.

In 2012, in contrast to the corporate sector, the resident household loan portfolio retained a higher level of quality despite a slight increase in the NPL ratio, from 3.0% in 2011 to 3.2% a year later. This rise resulted largely from some weakening in the quality of consumer loans, with the related NPL ratio increasing by 0.7 percentage point to 5.7% by the end of 2012. In the case of mortgage loans, the NPL ratio remained unchanged at 2.6%. The household loan portfolio represents 44.4% of total loans, but accounts for only 17.4% of total NPLs, reflecting a higher quality (see Chart 3.13). Factors contributing to the favourable asset quality of household loans are the high employment level in Malta and the increase in net financial wealth of the household sector. Furthermore, the tendency of households to give priority to their debt servicing obligations contributes positively to the high quality of mortgage loans.

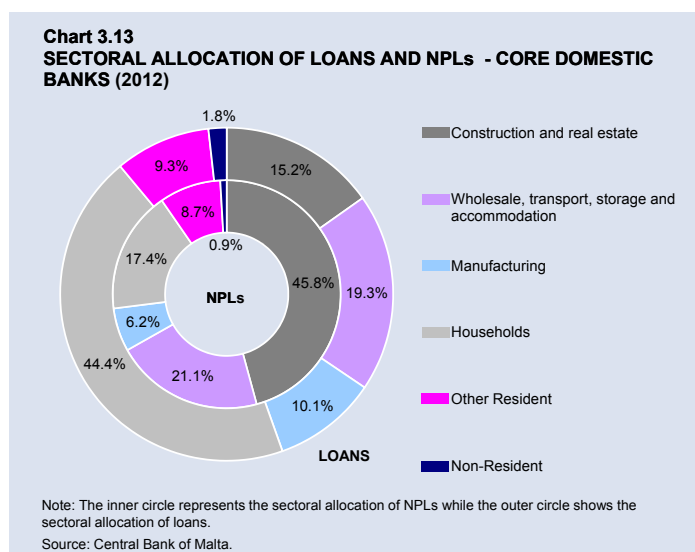
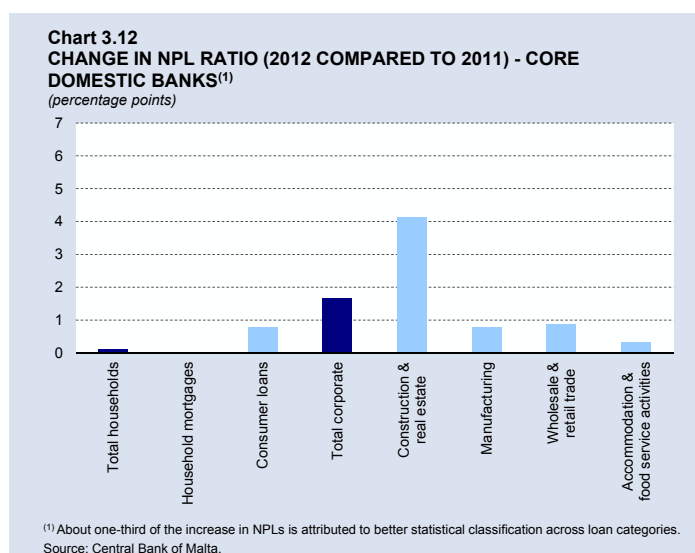
3.2 Other asset holdings

Despite the persistent negative impact of the euro area sovereign debt crisis on financial markets, core domestic banks continued to adopt a prudent approach to their asset management during 2012. Their holdings of assets from stressed euro area countries declined further while those from higher rated euro area sovereign states increased. The banks also continued to hold significant investments in high quality financial assets of non-euro area countries. Meanwhile, the banks' holdings of local government securities remained predominant, the prices of which were unaffected by the euro area crisis.

3.2.1 Foreign asset holdings

At the end of 2012, the foreign asset holdings of core domestic banks amounted to almost €2.9 billion, equivalent to 19.4% of total assets. Euro area asset holdings amounted to €1.1 billion or 7.2% of total assets, slightly lower than the 8.0% reported in 2011.⁹ During 2012 such holdings declined by 6.5%, with the bulk invested in financial assets of strong economies. Holdings of assets by euro area countries under stress

⁹ Euro area asset holdings include securities and placements with banks but exclude Maltese assets and any holdings with the Central Bank of Malta.



accounted for 12.9% of the total aggregate of euro area asset holdings, down from about 31.4% a year earlier. Meanwhile, non-euro area asset holdings amounted to €1.8 billion, equivalent to 12.2% of total assets at the end of 2012. The largest holdings were allocated in the UK and consisted predominantly of placements with banks (see Chart 3.14).

As observed in Chart 3.15, securities accounted for almost two-thirds of total euro area holdings of core domestic banks. In this regard, monetary financial institutions (MFI) were the most significant counterparties, notwithstanding the fact that banks' holdings of such securities and placements (loans and deposits) were lower in 2012. Similarly, banks also reported reduced holdings of assets issued by non-MFI private companies, but they increased their holdings of sovereign bonds.

Although sovereign bond holdings increased by 22.0% during the year, these still amounted to just 1.1% of total assets, up from 0.9% in 2011, mainly reflecting higher holdings of sovereign debt, which continued to be relatively insulated from the sovereign crisis in the euro area. Around 75% of euro area sovereign bonds held by core domestic banks are rated AA or better. Meanwhile, sovereign

bonds issued by stressed countries accounted for just 0.23% of total assets and represented 21.5% of the total euro area sovereign bond portfolio. When compared with their Tier 1 capital, such holdings declined from 4.7% to 4.4%. This low exposure, together with the gradual narrowing of the spread between most euro area sovereign bonds and the German bund, has contributed to an easing of contagion risk for core domestic banks.

3.2.2 Domestic government paper

Throughout 2012 domestic government paper remained an attractive investment asset for core domestic banks. In fact, despite a 2.9% drop in holdings of domestic government paper, these still accounted for half of the banks' investment portfolio, amounting to almost €1.7 billion and corresponding to 11.3% of their total balance sheet. At the end of 2012, the banks' holdings of Malta Government Stocks (MGS) increased marginally over that prevailing in 2011, whereas treasury bill holdings declined. The majority of such holdings will be redeemed by 2018, with banks holding the largest proportion of these stocks

Chart 3.14
ASSET HOLDINGS OF SELECTED COUNTRIES - CORE DOMESTIC BANKS (2012)
(EUR millions; per cent)

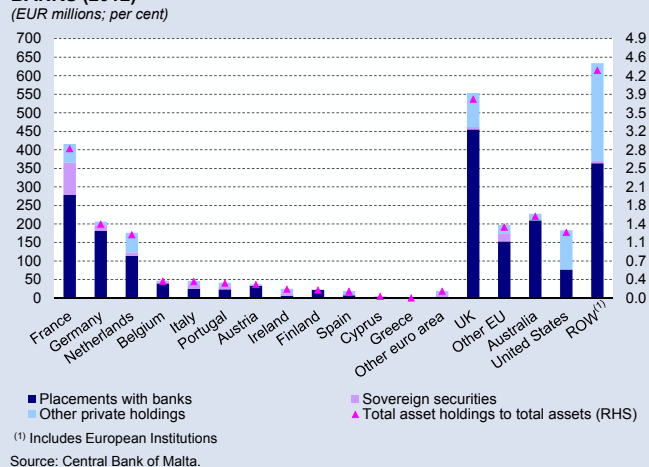
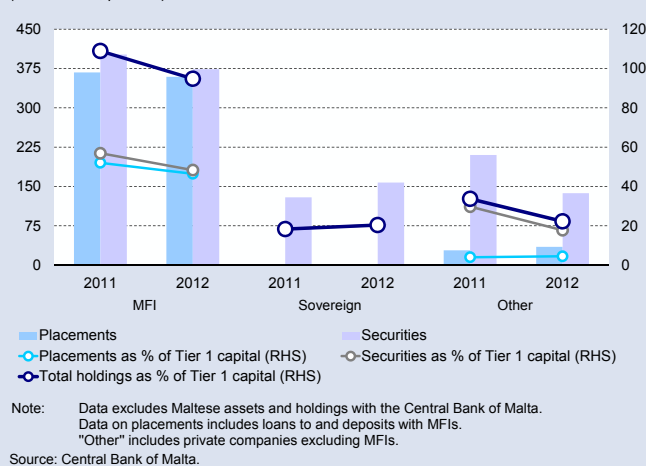


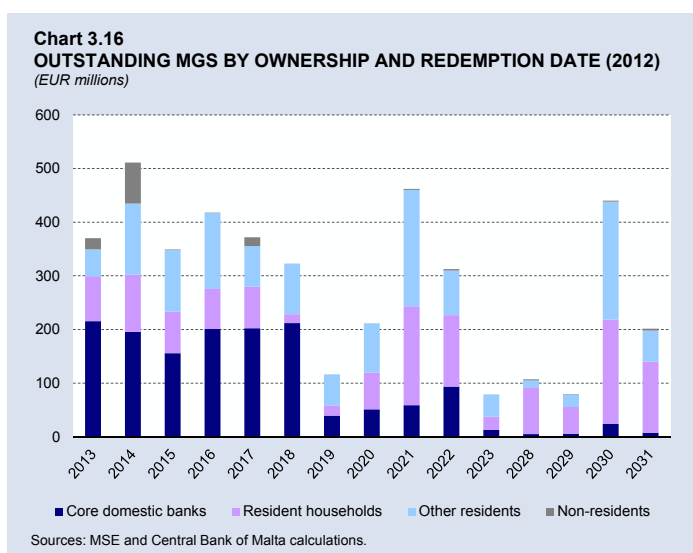
Chart 3.15
EURO AREA HOLDINGS - CORE DOMESTIC BANKS
(EUR millions; per cent)



(see Chart 3.16). It is expected that during 2013 the Government will implement the third stage of the MGS Switch Auctions Programme, which is aimed at lengthening and smoothening the interest and redemption profile of the existing MGS debt portfolio.

The relatively smooth trend in MGS yields and prices throughout 2012 was reflected in the stability of the spread of the ten-year MGS vis-à-vis the German bund of similar tenor. Both sovereign securities experienced a drop in their respective long-term interest rates, thus lowering their debt servicing costs.

The limited participation of non-resident financial investors contributed to the sustained stability in the MGS market.¹⁰ This is confirmed by the consistent and strong demand for newly issued MGS in 2012. Consequently, government exposure to rollover risk remains remote, especially in the light of recent developments in the local capital market, where the Government was able to cover more than half of its refinancing needs for 2013 in its first bond auction listed in March 2013. In addition, this market is largely characterised by a buy-to-hold approach, with limited secondary market turnover, reinforcing the low roll-over risk. Indeed, the average daily trading in MGS amounted to €2.2 million in 2012, equivalent to around 0.05% of the average outstanding MGSs for the year.

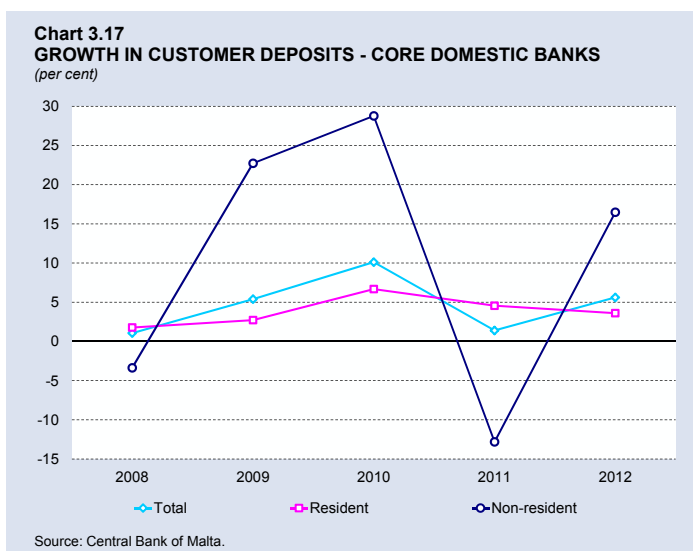


3.3 Funding

The banks' funding and liquidity situation remained stable during 2012. Banks continued to finance the bulk of their assets through customer deposits, with the latter accelerating in 2012 when compared with 2011. Wholesale and Eurosystem funding remained a minor source of funding for core domestic banks.

3.3.1 Customer deposits

During 2012 the banks' customer deposit base expanded further and was equivalent to 82% of total liabilities, 1.6 percentage points higher than a year earlier. Indeed, customer deposits grew at a faster pace than in 2011, up by 5.6% year-on-year compared with 1.4% in 2011 (see Chart 3.17). Resident deposits rose by 3.6%, while non-resident deposits registered significant gains, with an increase of 16.5% more than offsetting the contraction of 12.8% a year earlier. This notwithstanding, non-resident deposits continued to follow an



¹⁰ At the end of 2012 MGS holdings of non-residents accounted for only 3% of the outstanding amount.

erratic trend as a result of volatile movements in corporate deposits.

Resident customer deposits increased at a slower pace in 2012, by 3.6% compared with 4.6% a year earlier. This rise was largely driven by household deposits, which cumulatively accounted for 59.5% of total customer deposits and almost half of total liabilities (see Chart 3.18). Household deposits, which are regarded as less volatile than corporate deposits, rose by 3.2%, in line with the expansion registered a year earlier. Growth in deposits occurred despite the strong private investment in new MGS issues and their

continuous oversubscriptions. Household deposits are projected to maintain an upward trend in 2013, given the expectations of lower inflation during the year and a further rise in employment income. On the other hand, these positive factors may be somewhat offset by GDP projections showing a rise in private consumption. Meanwhile, resident corporate deposits decelerated over the previous year, growing by 3.1% in 2012 (12.4% in 2011).

From a currency structure perspective, the acceleration in resident customer deposit growth was driven by euro denominated deposits, whereas in the case of non-resident deposits the rebound in the growth rate resulted from both euro and other European Union currency-denominated deposits.

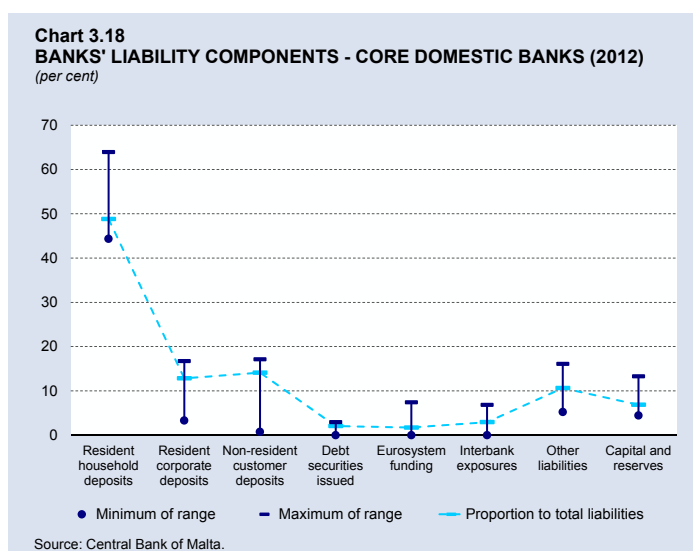
From a maturity viewpoint, over the years a number of banks offered fixed-term deposit products with longer maturities, some of which at variable rates (linked to developments in pre-set international indices). These products contributed to maintain a somewhat higher share of longer-term deposits, which stood at around 9% in both 2011 and 2012, compared with 7.3% in 2010.

The flow of deposits reported by core domestic banks remained positive over the year, despite slower economic growth, the attraction of a number of bond issues in the capital market and the competition for deposits from non-core domestic banks. The weighted average interest rate paid on resident deposits excluding MFIs by core banks stood at 1.2% at end-2012, lower than that paid by non-core domestic banks, which stood at 3.5%. This notwithstanding, core banks had ample levels of liquidity as reflected in loan-to-deposit ratios, which remained consistently low across all banks, hovering at around 70% on aggregate and considerably lower than the euro area average of 111% (refer to Chapter 4, Section 4.1, Chart 4.5).

3.3.2 Eurosystem and wholesale funding

In line with previous years, core domestic banks only made limited use of Eurosystem funding. Indeed, at the end of 2012, only around 14% of their eligible securities were pledged with the Central Bank of Malta as collateral for monetary policy operations. Furthermore, since most of the collateral placed with the Bank by core domestic banks consists of good quality assets, the collateral pool of banks is generally shielded from negative implications of sudden price movements that affected securities of relatively inferior quality.

At end-2012, Eurosystem funding amounted to 1.7% of total liabilities, slightly higher than the level of 1.5% registered a year earlier. This funding mostly reflected the participation by some banks in the three-year long-term refinancing operations conducted by the European Central Bank (ECB) in December 2011 and



February 2012. Whereas this non-standard form of financing was introduced by the ECB primarily to alleviate liquidity pressures facing banks, the local banks' interest in the facility was mainly due to its low cost, implying opportunities for more remunerative investment of such funds. In the early months of 2013, most of these funds were repaid, bringing down the proportion of Eurosystem funding in total liabilities to just 0.6%.

Core banks continued to make little use of interbank funding. Their exposure amounted to only 2.1% of total liabilities at the end of 2012, of which about one-seventh was in the form of interbank deposits. A further 2.1% of total liabilities were financed through the use of debt securities issued by banks, which increased by 15.2% during the year.

4. RESILIENCE OF CORE DOMESTIC BANKS

The banking sector remained resilient in the face of challenges posed by the macro-financial environment. Banks continued to expand their balance sheet and to strengthen their capital buffers. The latter was possible owing to a continuing positive performance. Furthermore, bank funding sources patterns remained sustainable, supported by further growth in customer deposits. The banks' underlying strength was confirmed by results of stress tests conducted by the Central Bank of Malta, notably the Tier 1 capital ratio which remained above the regulatory minima under extreme, but plausible scenarios.

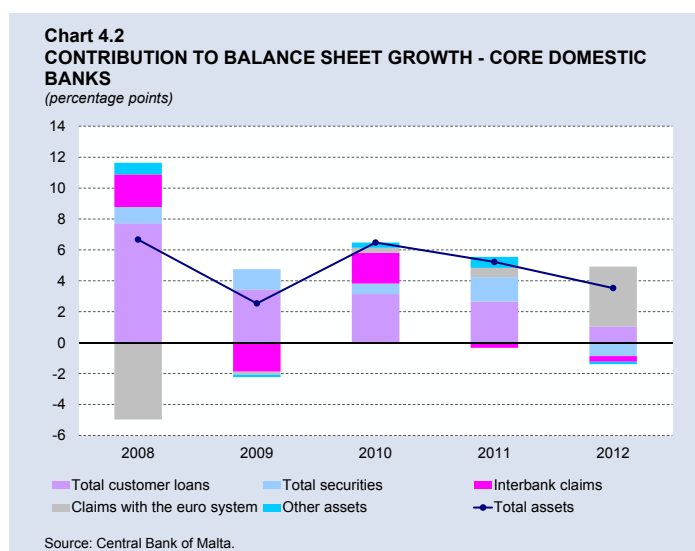
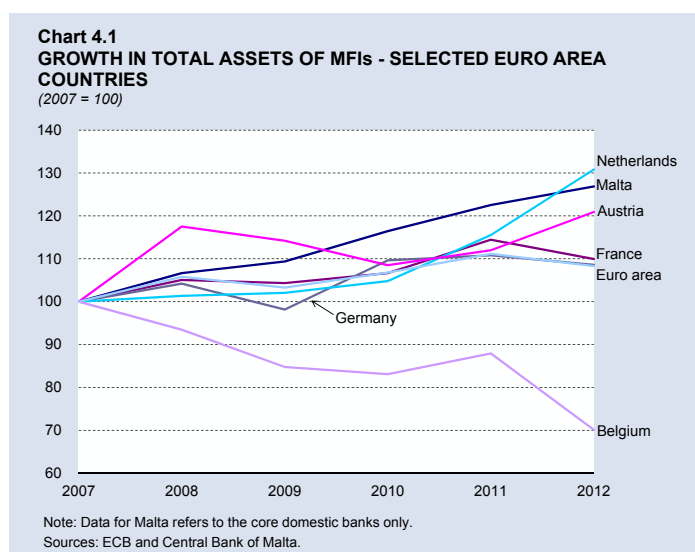
4.1 Balance sheet developments

During 2012 the total assets of core domestic banks continued to expand, although at a slower pace than in the previous year. These grew by an annual 3.5%, compared with 5.2% in 2011. As indicated in Chart 4.1, total assets of core domestic banks rose consistently over the five years to 2012. In this regard, the domestic banks' performance contrasted sharply with banks in several euro area countries, as the former downsized their balance sheet to improve their solvency ratios.

Loan portfolios contributed around 30% of the expansion in banks' total assets during 2012 (see Chart 4.2). This occurred despite the slowdown in credit growth to 1.8% from 4.5% in 2011. Lending to households, specifically mortgages, grew by 5.3% whereas corporate lending contracted by 1.1% (see Chart 4.3). As a result, the banks' loan portfolio accounted for 57.5% of total assets.

Higher claims on the Eurosystem, predominantly deposits with the Central Bank of Malta, was the other major driver of the expansion in total assets. This reflected primarily one bank's regular participation in the Eurosystem's fixed-term deposit auction. The expansion in these asset classes was partly offset by a fall in interbank claims and holdings of securities, which declined by 4.4% and 3.5%, respectively.

During the year core domestic banks disposed part of their fixed income securities holdings, which thus contracted to around 23% of banks' total assets at the end of the year compared with 24.5% in the previous year. The share of

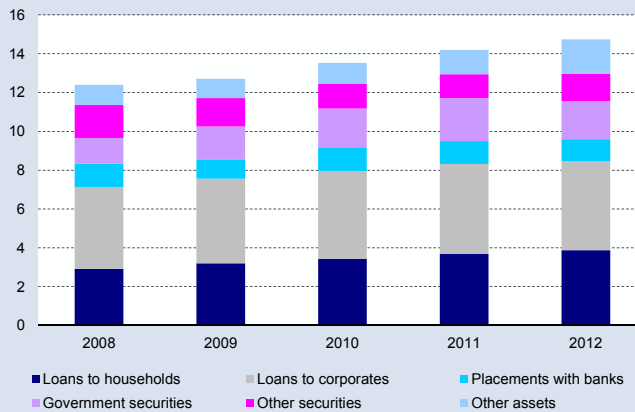


securities held for trading purposes remained at a low level, accounting for only 0.7% of the total securities portfolio. Securities “designated at inception at fair value through profit and loss” made up 16.6%, while the rest of the portfolio was classified either as “available for sale” (45.6%) or as “held to maturity” (37.1%). The latter has no direct impact on the profit and loss accounts of the banks.

Domestic securities accounted for 52.7% of the total securities portfolio (see Chart 4.4). These consisted almost entirely of Malta Government Securities (MGS), reflecting their attraction as a secure investment and an eligible asset for collateral purposes in connection with refinancing operations undertaken with the Eurosystem. However, during 2012 banks reduced their holdings of MGS and also lowered their exposure to foreign sovereign bonds. The decline in the banks’ holdings of sovereign securities was partly compensated by a rise in their holdings of foreign private sector securities. These rose to almost 40% of the banks’ securities portfolio and were spread out across a number of countries. This switch in investment strategy reflected the banks’ efforts to obtain better yields on their investments, given the prevalent low interest rate environment.

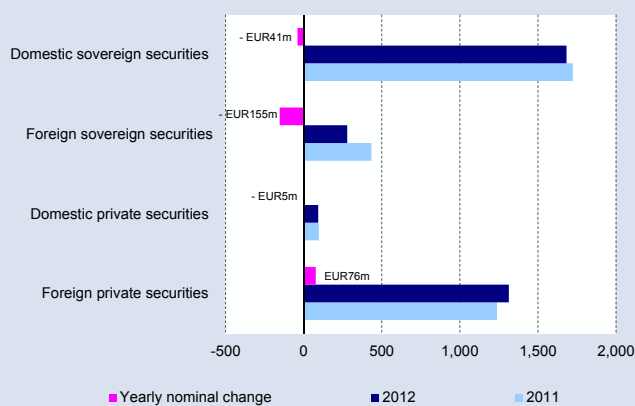
Throughout 2012 banks continued to fund themselves mainly through customer deposits. These increased by 5.6% and accounted for 82% of total liabilities. The faster growth in customer deposits when compared with loans contributed to the prudent level of the loan-to-deposit ratio which, at 70.1%, was significantly lower than the average of the euro area. The latter, although declining steadily over the past year, remained well above 100% (see Chart 4.5).

Chart 4.3
DISTRIBUTION OF BANK ASSETS - CORE DOMESTIC BANKS
(EUR billions)



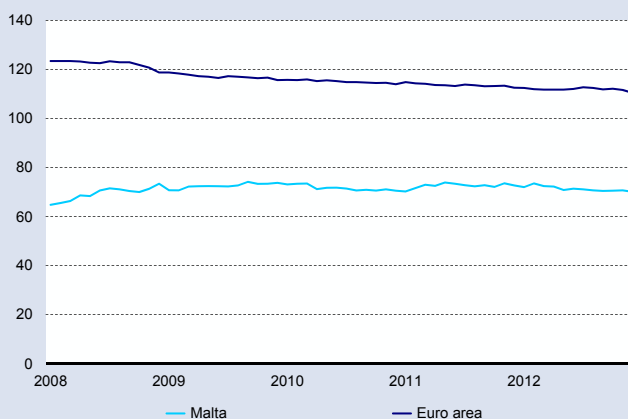
Source: Central Bank of Malta.

Chart 4.4
SECURITIES PORTFOLIO - CORE DOMESTIC BANKS
(EUR millions)



Source: Central Bank of Malta.

Chart 4.5
CUSTOMER LOAN-TO-DEPOSIT RATIO - CORE DOMESTIC BANKS
(per cent)



Sources: ECB and Central Bank of Malta.

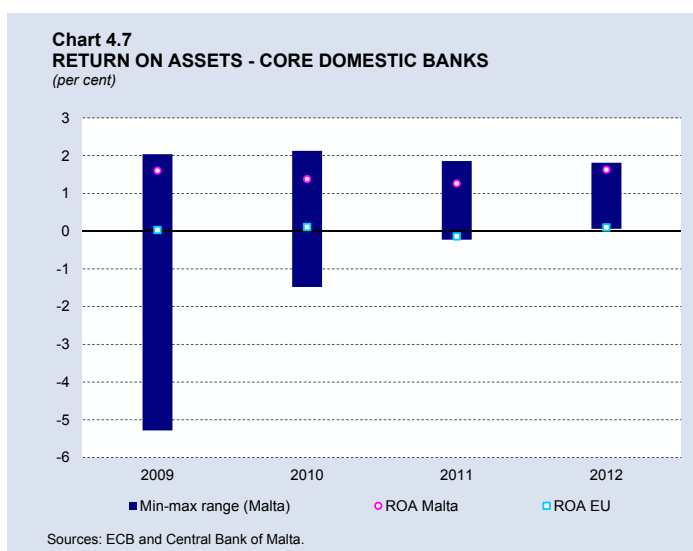
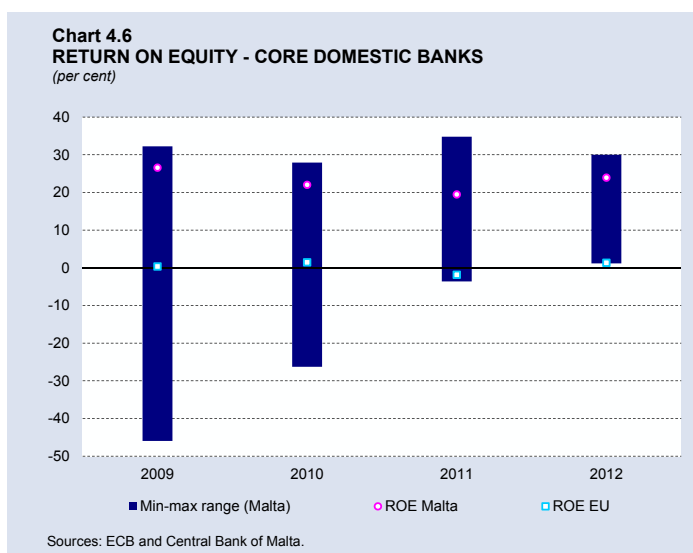
Interbank funding decreased by half mainly owing to lower intragroup financing. However, given the banks' low reliance on such funding, this decline had no significant impact on banks' core operations and liquidity position. Debt securities issued by banks increased during the year, but remained a marginal source of funding, accounting for 2.1% of total liabilities.

During 2012 Eurosystem funding increased by 17.2% but, overall, it also remained a low source of funding, accounting for just 1.7% of total liabilities. The rise in such funding was due to the rolling over of maturing short-term funds and the subscription to long-term financing at a low cost. However, in the early months of 2013, a significant part of the three-year longer-term refinancing operations was paid back, reducing such funding to just about 0.6% of total liabilities.

4.2 Profitability

On aggregate, core banks reported higher profits for the financial year 2012. These were up by 34.5% on a year earlier and were mainly driven by buoyant trading profits and, to a lesser extent, by increased returns from intermediation activities.¹ This notwithstanding, not all banks reported a rise in their profits although the dispersion between them in terms of their performance narrowed during the year. The banks' return on equity (ROE), increased from 19.5% in 2011 to 23.9% in 2012 (see Chart 4.6) while their return on assets (ROA) improved by 0.3 percentage point to 1.6% (see Chart 4.7). Compared with small banks in the EU (with an average ROE and ROA standing at 1.3% and 0.1%, respectively) the overall profitability of core domestic banks remained higher.²

As in previous years, the main source of bank profits was net interest income, which during 2012 accounted for 66.8% of gross income, down from 72.5% a year earlier. During the year net interest income increased by 4.5%, reflecting returns from financial intermediation activities (see Table 4.1). Although deposits grew faster than loans, the banks' extensive reliance on short-term deposits paying very low rates of interest kept funding costs at low levels.



¹ Trading profits include gains or losses on disposal of financial assets and fair value movements.

² Small banks in the EU are defined as those whose total assets are less than 0.005% of the total EU consolidated assets.

Table 4.1
MAIN COMPONENTS OF THE PROFIT AND LOSS ACCOUNT - CORE DOMESTIC BANKS

EUR millions

	2008	2009	2010	2011	2012
Total net interest income	276,611	250,988	292,916	314,414	328,571
Net interest income on intermediation	74,866	126,181	206,759	223,487	238,645
Other net interest income	201,745	124,807	86,157	90,927	89,925
Non interest income	24,190	151,033	121,619	119,479	163,316
Trading profits ⁽¹⁾	(80,707)	30,057	1,575	(27,770)	21,573
Other non-interest income	104,897	120,976	120,044	147,248	141,742
Non interest expense	(199,661)	(203,024)	(227,438)	(260,032)	(258,107)
Net profit before tax	101,141	198,998	187,097	173,861	233,779

⁽¹⁾ Trading profits (fair valuation movements and gains/losses on traded securities).

Non-interest income also increased notably over the year as banks recorded substantial fair value gains on their securities portfolio. These amounted to over €21 million. Meanwhile, earnings from other non-interest sources declined slightly, mainly as a result of a base effect related to the sale of a business line by a major bank in 2011. Lower dividend income from subsidiary companies also impacted on non-interest income, whereas net fees and commissions (which account for the bulk of non-interest income) remained stable during the year.

With regard to non-interest expenses, these were broadly unchanged from the previous year. Thus, while banks did not incur extraordinary costs as in the previous year, they faced higher net impairment charges (write-offs, write-backs, provisions and recoveries), which increased by almost €8 million when compared with 2011.³ In the case of net specific and collective provision charges, these were up by €24.3 million, despite a fall of €16.4 million in bad debt write-offs.

The banks' robust profit performance continued to be underpinned by their traditional business models and by their stable income and funding sources. Nevertheless, the persistent weakness in domestic demand and the low interest environment may put profit margins under pressure. In particular, the deceleration in credit demand and the rising trend in non-performing loans (NPL) could impact negatively on profit performance. In this respect, and given the regulatory changes that will come into force by 2019, the core banks were encouraged to adopt prudent dividend policies to build up their capital buffers in line with international regulatory obligations and thus strengthen their core capital base.

4.3 Loan loss provisions

During 2012 banks took steps to boost their loan loss provisions. These were raised by 25.7%, exceeding the increase of 12.5% in the level of NPLs. The overall expansion in total provisions reflected both higher specific and collective provisions, which were augmented by 24.5% and 27.3%, respectively. Specific provisions were increased mainly to cover NPLs in the construction and the household sectors. The remaining increase was spread more broadly over other major economic sectors.

The higher level of loan loss provisions contributed to a rise in the coverage ratio (defined as total provisions to total NPLs) which increased by 2.3 percentage points to 22.1% in 2012 (see Chart 4.8). An alternative coverage ratio based on International Financial Reporting Standards also improved from 26.1% in 2011 to 32.1% in 2012.

³ The extraordinary costs incurred in 2011 relate to an out-of-court settlement and early retirement schemes.

The ratio of specific provisions to total NPLs improved by over 1 percentage point, reaching 11.8% by the end of 2012. The specific provisions-to-NPL ratio with respect to the household sector stood at 12.6%, while for the corporate sector, this stood at 11.7%. Meanwhile, it was estimated that bank collateral covered 75.4% of total NPLs.⁴ In case of immovable property as collateral, banks apply substantial haircuts, often in the region between 20% and 30%.

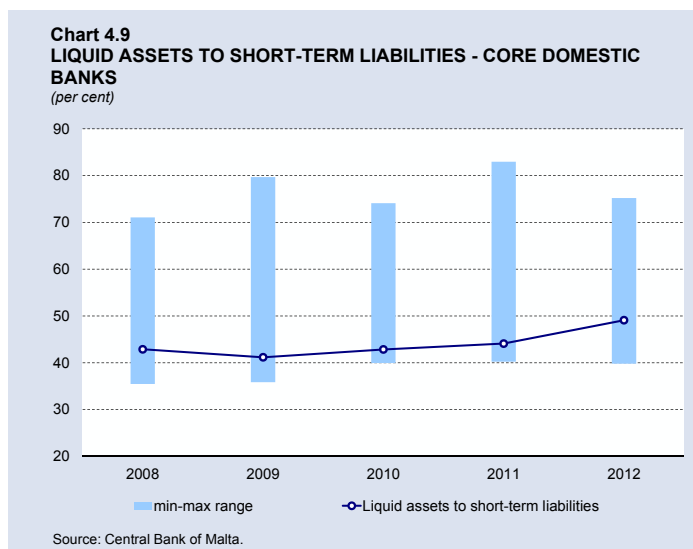
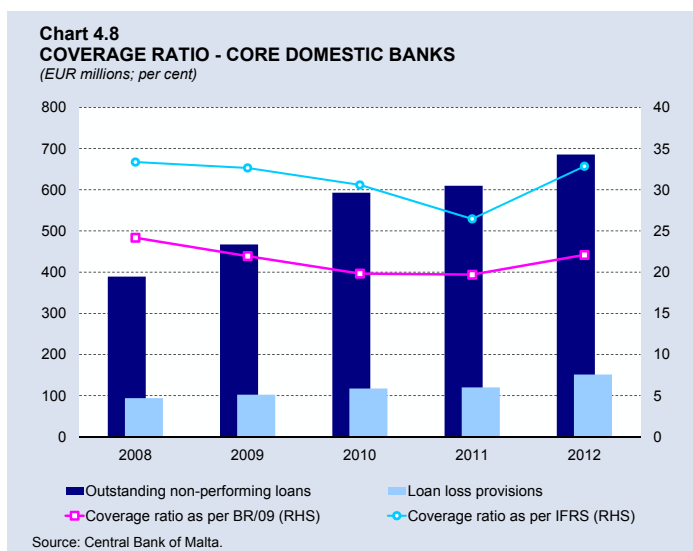
4.4 Liquidity

During 2012 the banks' liquidity position improved further. The liquidity ratio, defined as liquid assets to short-term liabilities, increased by 5 percentage points to 49.1% in 2012 (see Chart 4.9). The liquidity ratio among core banks varied from a low of 39.8%, which is still well above the 30% regulatory threshold to a high of 75.2%. The banks' strong liquidity position is supported by marketable debt securities, which account for more than half of liquid assets. The remainder are almost equally split between balances held with other credit institutions and the Central Bank of Malta.

On the liabilities side, about 55% of total deposits consisted of savings and current deposits. Although such deposits have in a historical context registered low volatility despite their liquid nature, they have the potential to be a source of instability if banks' balance sheets come under stress. The provisions governing the liquidity coverage ratio (LCR) under the new Basel III framework will require banks to maintain enough liquid assets to meet the notional amount of cash outflows occurring over a 30-day period. The full regulatory requirements of the LCR will be gradually phased in, with a full implementation by January 2019. The first milestone, however, is to be met by January 2015 with a minimum LCR of 60%. Over the past years banks began restructuring their balance sheets to meet new regulations and it is expected that they will meet the new requirements before the deadline.

4.5 Capital and leverage

Throughout 2012 the capital position of core domestic banks improved further as evidenced by the level of the Capital Adequacy Ratio (CAR), which rose by 0.8 percentage point to 14.3% by the end of 2012. This is well above the 8% statutory requirement. This improvement was recorded across almost all core



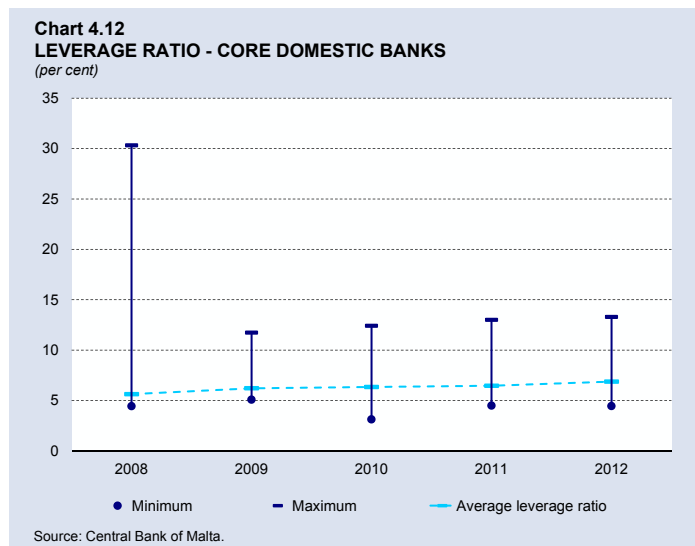
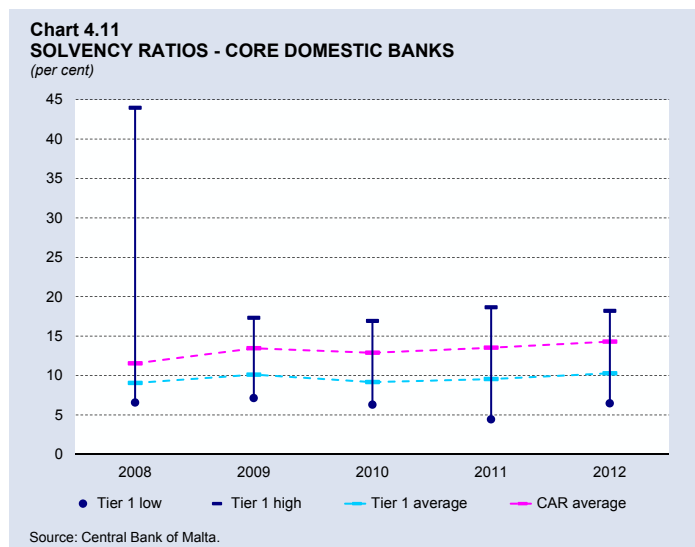
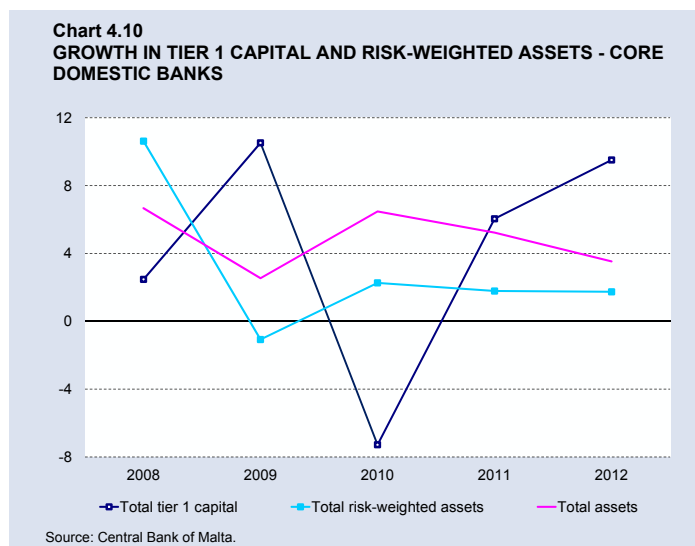
⁴ All collateral, including property-backed collateral, is included in this ratio.

domestic banks. The higher CAR resulted from further accumulation of total own funds, which expanded by 7.6% on a year earlier, and more than compensated for the increase in risk-weighted assets, which rose by 1.7% in 2012 (see Chart 4.10). Risk-weighted assets also grew at a slower pace than total assets, owing to the stronger accumulation of assets with lower risk weights by banks, including mortgage loans.⁵ As a result, the overall risk profile of banks, defined as risk-weighted assets to total assets, declined slightly to 51.0% from 51.9% in 2011.

Tier 1 capital increased by 9.5% and contributed €67.2 million to the overall rise of €75.8 million in total own funds. The increase in Tier 1 capital was driven mainly by retained earnings, which in turn was partly converted into a new share issue. This improved the quality of banks' Tier 1 capital and, as a result, the Tier 1 capital ratio rose by 0.7 percentage point to 10.3% at the end of the year, significantly higher than the threshold of 4.0% required under local regulations (see Chart 4.11). The level of this ratio differed substantially among core domestic banks, with the lowest ratio standing at 6.5% while the highest one stood at 18.2%. The increase in Tier 2 capital was more contained, up by 2.9% or €8.6 million. This was achieved mainly through the augmentation of collective provisions.

At the same time the leverage ratio, defined as capital and reserves to total assets, improved by a further 0.4 percentage point to 6.9% (see Chart 4.12).⁶ Almost all banks registered a modest rise in this ratio.

The improvement in banks' capital buffers observed over the years is



⁵ The core domestic banks follow the "standardised approach" for capital adequacy, meaning that the calculation of risk-weighted assets is based on pre-set weighting for various asset categories.

⁶ The computation does not, however, consider off-balance-sheet exposures. These are included in the calculation of the forthcoming leverage ratio requirement under the CRD IV framework.

a positive development against a backdrop of increasing credit risk and relatively subdued economic activity. Furthermore, the strengthening of capital enables banks to meet the requirements of the forthcoming CRD IV framework, which is expected to be implemented in 2014. This framework will allow a gradual build-up of capital and will also introduce new variable capital buffers, such as systemic risk buffers and counter-cyclical buffers.

4.6 Stress tests

Stress testing exercises continued to be conducted by the Central Bank of Malta during 2012 to assess the financial system's resilience to extreme yet plausible events. These stress tests broadly captured the elements of credit risk, sovereign risk and liquidity risk. Over the last year, the methodology of stress tests was further improved although the scenarios considered are the same as those presented in the previous *Report*, namely:

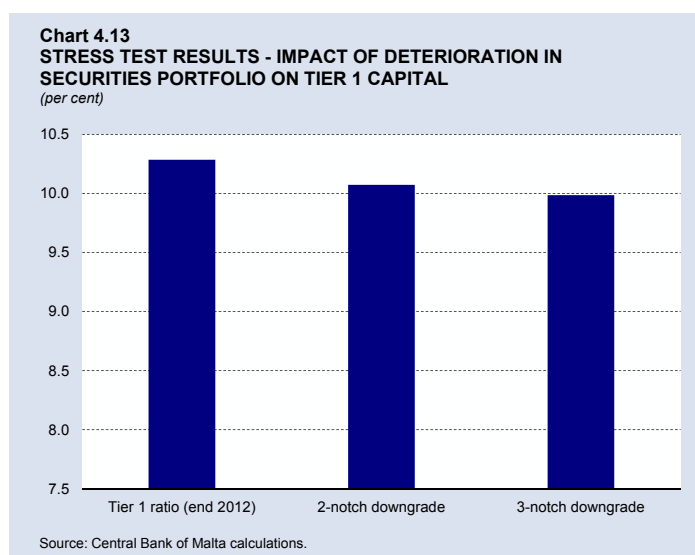
- (i) credit quality deterioration;
- (ii) a drop in property prices;
- (iii) an increase in NPLs owing to adverse macroeconomic conditions;
- (iv) persistent deposit withdrawals.

The Bank considers the probability of the occurrence of the first three scenarios to be low, while a deposit run materialising is deemed to be remote. Results of stress tests are to be considered as indicative, given that these tests are univariate in nature and do not capture second-round effects.

Scenario 1: Credit quality deterioration in the securities portfolio

This stress test assesses the impact on core banks' balance sheets of a deterioration in the credit quality of the securities portfolios. The test assumes a credit grade downgrade of two to three notches.⁷

At the end of 2012 approximately 90% of banks' total securities attracted a credit rating above A-, and almost 99% of securities were classified as investment grade. Moreover, the securities portfolio only represents around 23% of core banks' balance sheets. Banks could comfortably withstand a two to three-notch downgrade in their securities portfolio, where their aggregate Tier 1 capital ratio remains significantly higher than the regulatory threshold. In fact, even under a three-notch downgrade, the aggregate Tier 1 capital ratio would remain around the 10% level (see Chart 4.13).⁸



⁷ In the event of deterioration in credit quality, assets are downgraded and associated probabilities of default (PD) increase in line with the underlying risk. Securities are categorised by credit rating as assigned by the official rating agencies, whereby the associated PD is applied to determine the expected loss. A distinction is made between assets that are held to maturity (HTM) and those which are not, since such a classification allows for different accounting treatment on banks' books. Risk-weighted assets are assumed to remain constant.

⁸ The results of tests are not comparable with those published in the previous *Report* since the PDs applied have been updated and the current test, unlike the previous one, excludes the loan portfolio.

Scenario 2: An increase in NPLs owing to adverse macroeconomic conditions

This scenario assumes that, following an adverse macroeconomic shock, NPLs in a number of key economic sectors increase within a range of 5% and 15%. The sectors included in the test are households, manufacturing, construction and real estate, wholesale and retail trade, and transport and accommodation. As a result of the assumed increase in NPLs, the level of provisions rises accordingly, translating into a drop in retained earnings and deterioration in the solvency state of the banks. Banks' capital ratios are also negatively influenced by this rise in NPLs, given that such loans attract a higher risk weight and hence require higher capital allocation.

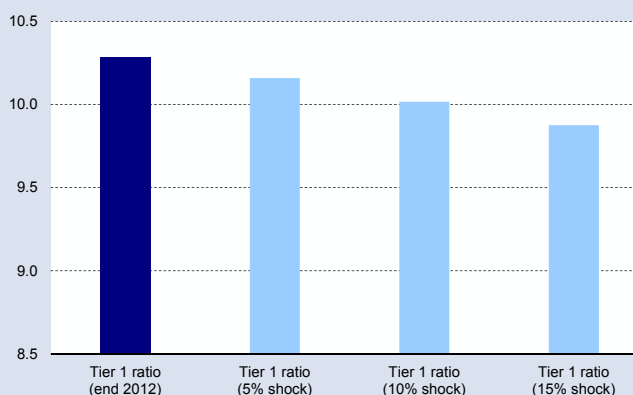
Stress test results reveal that, even under the most extreme scenario (i.e. a 15% increase in NPLs in key economic sectors), the banks' aggregate Tier 1 capital ratio drops to 9.9%, i.e. remains comfortably above the regulatory threshold (see Chart 4.14).⁹

At a sectoral level, the deterioration in the NPLs in the construction and real estate sector is the main cause of the fall in the Tier 1 capital ratio (see Chart 4.15), reflecting the stronger share of NPLs in these sectors (refer to Chart 3.13).

Scenario 3: A drop in property prices

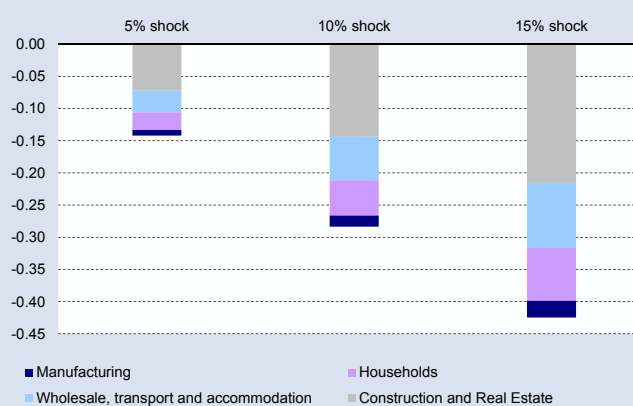
This scenario considers a drop in property prices to varying degrees, which in turn has a negative impact on loan collateral values. The assumed fall in property prices is applied on the value of collateral, which is already subjected to haircuts by banks.¹⁰ This ensures that a worst case scenario is applied in this test since haircuts on property values are applied by banks when sanctioning loan facilities. Moreover, the test assumes that, as collateral values decline, provisions for existing NPLs would need to be replenished and raised accordingly. This scenario further penalises banks as it assumes a significant increase in NPLs owing to the negative wealth effect of the drop in property prices, which in turn leads to a further rise in provisioning levels.

Chart 4.14
STRESS TEST RESULTS - IMPACT OF AN INCREASE IN NPLs IN KEY ECONOMIC SECTORS ON TIER 1 CAPITAL
(per cent)



Source: Central Bank of Malta calculations.

Chart 4.15
STRESS TEST RESULTS - IMPACT OF AN INCREASE IN NPLs BY SECTOR ON TIER 1 CAPITAL (2012)
(percentage points)



Source: Central Bank of Malta calculations.

⁹ The test is only broadly comparable with results produced in the previous *Report*, since the methodology was slightly modified.

¹⁰ Around 90% of banks' collateral consists of immovable property.

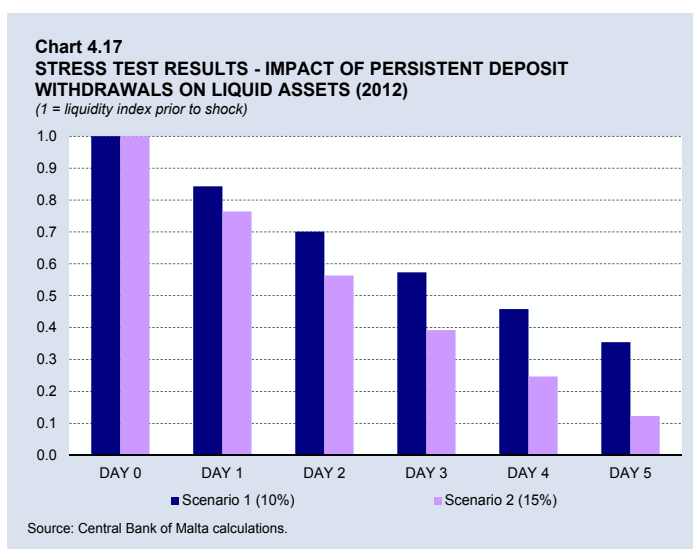
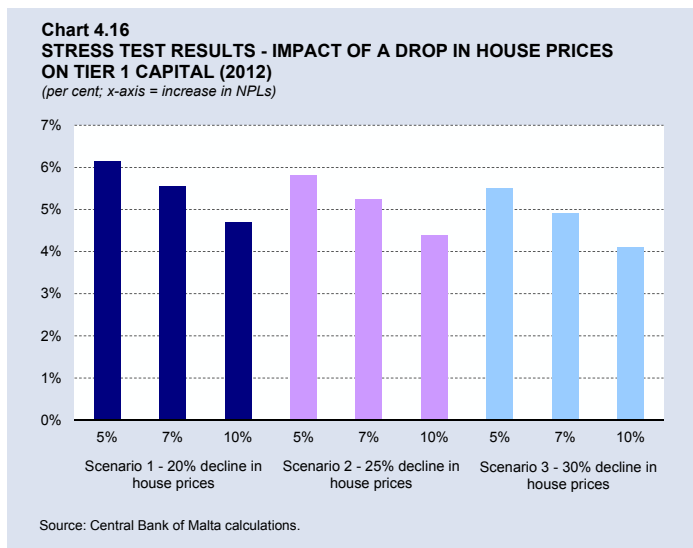
Results indicate that, on aggregate, banks would be able to withstand a 30% fall in collateral values and a concurrent increase in NPLs of 10%, before their Tier 1 capital ratios drop below the regulatory threshold (see Chart 4.16).¹¹

Scenario 4: Persistent deposit withdrawals

Under this scenario the banks' liquidity position is subject to persistent deposit withdrawals in the range of 10% to 15% for five consecutive days. During this period, as counter-balancing capacity, banks were assumed to only utilise the range of highly liquid assets stipulated in the Banking Rules.¹² The test is therefore based on the extent of in-house liquidity and ignores any spare capacity, which can be tapped to further increase the pool of liquid assets. Results indicate that following persistent deposit withdrawals of 15%, banks on aggregate would remain liquid. On a bank-by-bank basis, one particular bank would require to tap into other funding sources to withstand the assumed five-day persistent deposit withdrawal period (refer to Chart 4.17).

As part of its financial stability assessment, during the year the Bank also repeated and extended the European Banking Authority (EBA) European Union-wide stress testing exercise on a number of relevant core and non-core banks. The exercise was carried out using the same methodology as that applied in the 2011 stress test, whereby banks were tested against a 5% Core Tier 1 (CT1) capital ratio benchmark. However, a number of refinements were made to the original methodology used in the EBA exercise to reflect recent developments in both the international macroeconomic environment and financial markets. The test sought to quantify credit risk in both the loans and securities portfolios, market risk in the securities portfolios, as well as the cost of funding.

Overall, the stress testing exercise demonstrated that the financial system as a whole is resilient to the scenario proposed by the EBA in its stress test. Even under the most extreme scenario, only one bank achieved a result below the established 5% CT1 threshold. This bank increased its CT1 ratio during 2012, and has plans to increase further its CT1 ratio during 2013.



¹¹ Results published in the *Financial Stability Review 2011* are not comparable with results published in this edition since the simulated increase in NPLs ranged from 10% to 20% in 2011 and from 5% to 10% in 2012.

¹² Most liquid assets held by domestic banks consist of marketable debt securities, namely MGS.

5. THE OTHER COMPONENTS OF THE FINANCIAL SYSTEM

Risks from other components of the financial sector, namely, non-core domestic banks, international banks, insurance companies and investment funds, continue to be deemed as low. The operations of non-core domestic and international banks remain skewed towards non-residents, with very few interlinkages with the domestic economy. Meanwhile, their performance and financial conditions are considered satisfactory. Similarly, the performance of the investment and insurance companies are seen as positive, supported by improved international market conditions.

5.1 Non-core and international banks

5.1.1 Non-core domestic banks

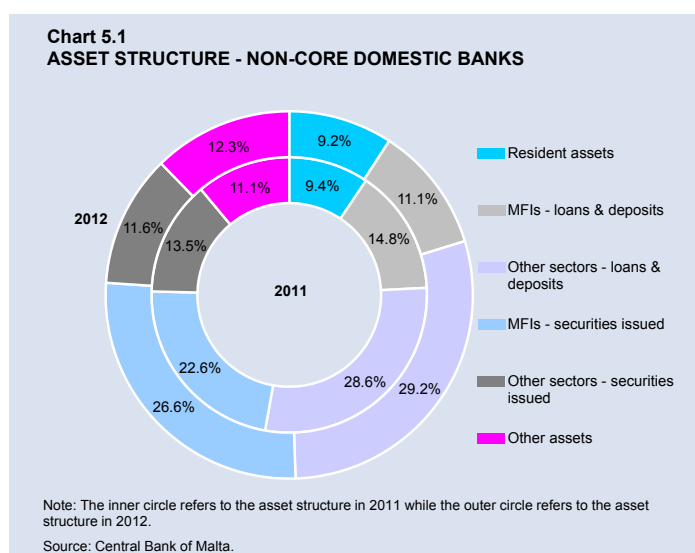
Eight banks are classified as non-core, of which four are foreign-owned, three are subsidiaries of other European Union (EU) banks and one is a branch of an EU bank.¹ The total assets of these banks are equivalent to 77% of gross domestic product (GDP), with their operations mainly oriented towards non-residents. Indeed, resident assets accounted for only 9.2%, whereas resident liabilities amounted to 16.4%.

Asset structure

During 2012 the growth rate in total assets of non-core domestic banks, which reached €5.2 billion, accelerated to 5.1%, up from 1.2% in 2011. While the increase in total assets was largely concentrated in one bank, no signs of deleveraging were recorded in the other non-core domestic banks. The expansion in total assets was largely driven by higher holdings of securities issued by non-resident banks, while the asset structure of the non-core group showed modest changes. The share of the non-resident loan portfolio contracted to 40.3% of the overall balance sheet value from 43.4% in 2011, whereas the securities portfolio, consisting mainly of debt issued by monetary financial institutions (MFI), grew to 38.3% of total assets from 36.1% a year earlier (see Chart 5.1).

Total lending decreased by 1.7% in 2012 and remained predominantly channelled to the non-resident corporate sector. Lending to the financial sector dropped by 28.9%. This contraction reflected movements in inter-bank lending, which more than halved, mainly in respect of intragroup funds. Meanwhile, lending to households and corporates increased by almost 10%.

From a geographical perspective, customer lending to non-EU residents remained prominent, although the proportion decreased from 53.4% in 2011 to 42.4% of total customer loans (see Chart 5.2). This was compensated by higher lending to residents in EU countries, representing 44% of total customer loans in 2012, up from 31.9% a year earlier. Resident customer loans remained relatively subdued, down from 14.8% of their total lending to 13.6% and equivalent to just 2.8% of total resident loans in Malta.



¹ Refer to *Financial Stability Review 2011* for the classification of banks.

Total non-performing loans (NPL) of non-core domestic banks declined throughout 2012 with the NPL ratio ending the year at 4.1%, down from 4.5% in 2011.

Geographically, the investment portfolio of non-core banks consists mainly of securities issued in EU countries, accounting for around 70% of total securities (see Chart 5.3). During the year these banks sharply reduced their holdings of securities issued in stressed countries in the euro area from 41% of total securities in 2011 to 20% by end-2012, a drop which was widespread, but particularly in Ireland, Spain, Greece and Portugal. The majority of these bonds consisted of debt issued by MFIs. Meanwhile, domestic securities accounted for only 7% of total securities, slightly higher than the 5.8% in 2011. These were practically all channelled into domestic government paper, which, nevertheless, only accounted for about 3% of outstanding domestic government paper.

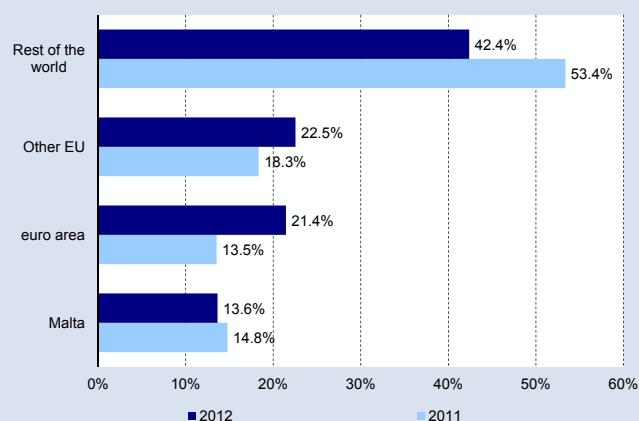
Funding structure

Non-core domestic banks obtained their funding primarily from the wholesale market, accounting for 50% of their total liabilities.² While no signs of parent bank funding pressures were observed, the funding composition of these banks shifted from intragroup funding to funding from other unrelated credit institutions. Meanwhile, financing obtained from the Eurosystem slightly decreased to 2.2% of total assets, down from 2.6% in 2011 (see Chart 5.4). Resident interbank liabilities of non-core domestic banks remained negligible at 0.22% of their total liabilities, indicating the lack of interconnectedness to the local financial system.

Customer deposits fund almost 25% of these banks' balance sheet.

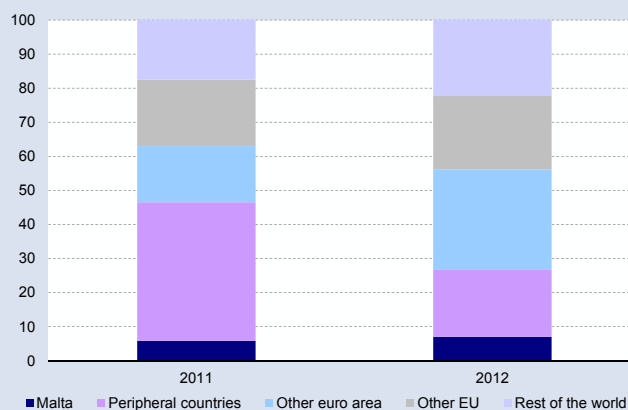
² This includes sales and repurchase agreements with both other MFIs and financial intermediaries.

Chart 5.2
CUSTOMER LOANS BY RESIDENCY - NON-CORE DOMESTIC BANKS



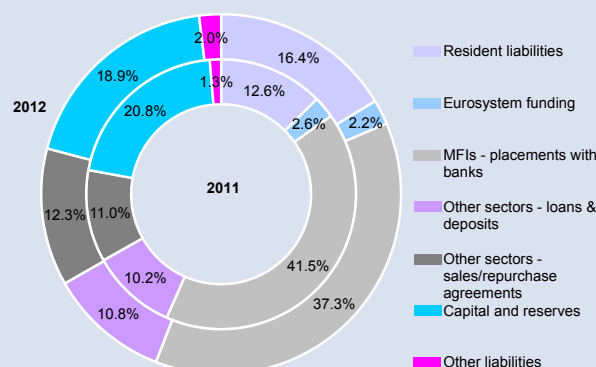
Source: Central Bank of Malta.

Chart 5.3
INVESTMENT SECURITIES BY RESIDENCY - NON-CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

Chart 5.4
LIABILITIES STRUCTURE - NON-CORE DOMESTIC BANKS



Note: The inner circle refers to the liabilities structure in 2011 while the outer circle refers to the liabilities structure in 2012.

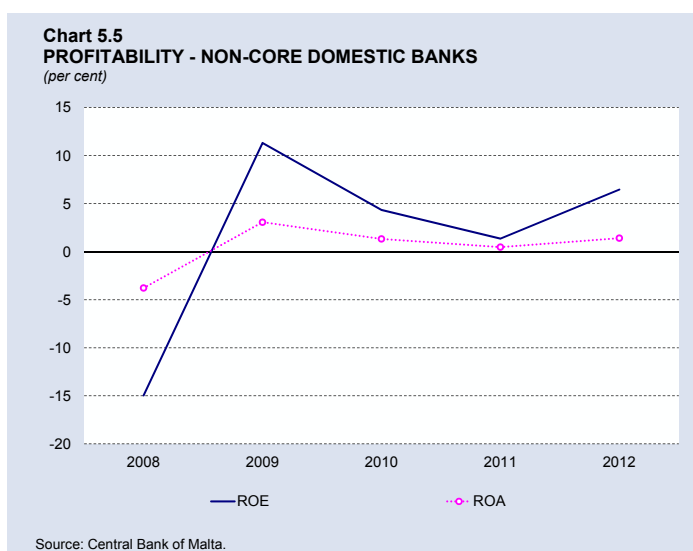
Source: Central Bank of Malta.

During the year resident customer deposits, which represent 12.4% of total liabilities, increased by 53.2%, bringing their proportion to over half of total customer deposits. Despite the fast growth rate, resident customer deposits held by these banks still represented just over 6% of total resident customer deposits, up from 4.2% a year earlier. The expansion in these banks' customer deposit base led to an increase in the amount of deposits covered by Malta's Depositor Compensation Scheme from 3.8% in 2011 to 6.2% of total covered deposits in the Maltese financial system.

The total value of securities issued on the Malta Stock Exchange (MSE) by three of the non-core domestic banks slightly increased throughout the year to around €100 million, equivalent to about 11% of the total value of listed private sector bonds on the Exchange. These securities are almost entirely held by residents, primarily households. Meanwhile, no developments were reported during the year for quoted shares issued by non-core domestic banks. Indeed, only one bank had resorted to this type of funding and its proportion amounted to around 3% of total listed private sector equities. The bulk of these shares are held by non-residents.

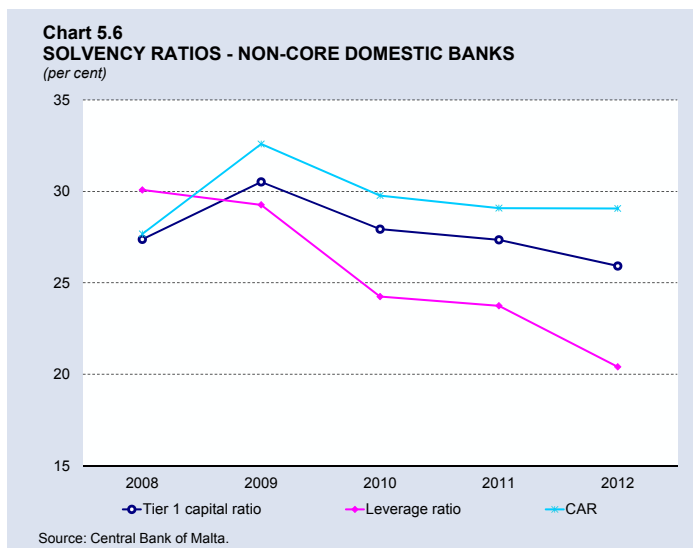
Profitability

During 2012 pre-tax profits of non-core domestic banks surged by more than 200%. This was largely attributable to one bank, which reported revaluation gains. On the other hand, another bank reported a noticeable contraction in profits mainly resulting from lower net interest income. Excluding these two particular banks, which reported considerable swings in their returns, the profits of the remaining non-core domestic banks increased by 27.3%. Apart from higher trading profits, non-core domestic banks also reported gains on the disposal of financial assets and lower net impairment charges. As a result of these developments, the return on equity (ROE) increased from 1.4% in 2011 to 6.5% in 2012, whereas the return on assets (ROA) rose to 1.4% from 0.5% over the same period (see Chart 5.5).



Solvency and liquidity

The non-core domestic banks' solvency ratios remained positive and relatively stable with the capital adequacy ratio (CAR) and Tier 1 capital ratios at 29.1% and 25.9%, respectively (see Chart 5.6). The leverage ratio (capital and reserves to assets) remained healthy, standing at 20.4% compared with 23.7% in 2011. Similarly, the liquidity ratio defined as liquid assets to short-term liabilities, continued to show high liquidity levels, standing at 82.4% at the end of 2012, which is well above the 30% regulatory requirement.



5.1.2 International banks

A total of 13 banks which operate in Malta are classified as international banks, of which three are foreign-owned, six are EU subsidiaries, two are non-EU subsidiaries and two are non-EU branches.³ At the end of 2012, total assets of these banks were equivalent to 493.7% of GDP. The operations of international banks remained almost exclusively oriented towards non-residents, largely influenced by the two non-EU branches owing to their comparatively large balance sheets. Indeed, these two branches represent almost 66% of the aggregated total assets of international banks. Resident assets and liabilities continued to account for a very small proportion of all international banks' balance sheet items, equivalent to only 1.9% and 1.4% of total assets, respectively.

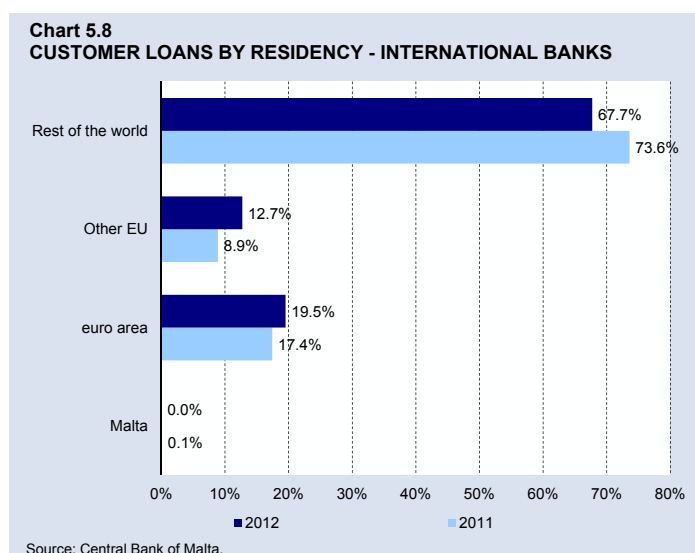
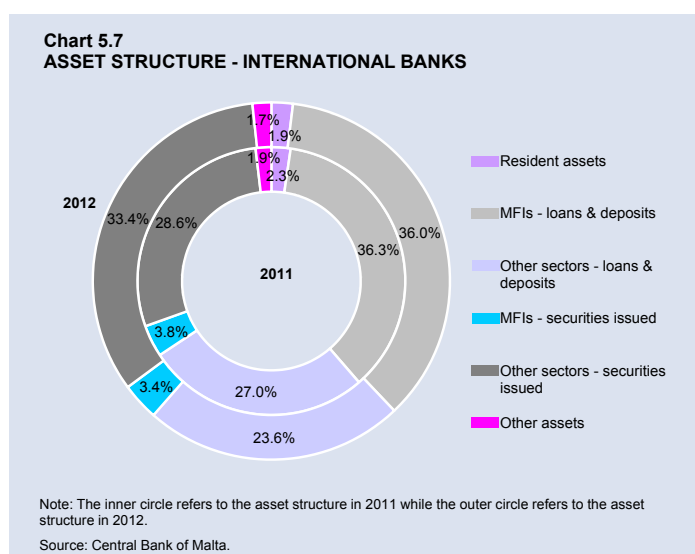
Asset structure

During 2012 the total assets of international banks expanded by 4.4%, compared with an increase of 1.5% in 2011, reaching €33.4 billion. However, at bank level, developments were mixed, with some banks reporting a contraction. The growth in total assets was mainly driven by higher holdings of Turkish government securities, reflecting the predominance of the two Turkish bank branches. The asset structure of international banks registered some modest shifts, with the share of the loan portfolio shedding over 3 percentage points to 59.6% of the balance sheet. The securities portfolio expanded from 32.4% of total liabilities in 2011 to 36.8% a year later (see Chart 5.7).

Total lending decreased by 10.3% in 2012, largely as a result of lower corporate sector loans, which now account for 54.1% of total lending compared with 56.4% in 2011. Lending to the financial sector, which accounts for around 46% of total loans, declined primarily owing to lower interbank lending to related banks and affiliates.

From a geographical perspective, customer lending remained highly biased towards non-EU countries, reflecting the operations of the two large Turkish branches. Indeed, the latter loans accounted for 58.5% of total customer loans. Lending to EU countries amounted to 32.2% of total customer lending, whereas resident lending totalled to less than 0.03% (see Chart 5.8).⁴ From an asset quality perspective, the NPL ratio remained generally low, at just 0.5%.

As in the case of the loan portfolio, the banks' investment portfolio consisted mainly of securities issued in non-EU countries, which accounted



³ Refer to *Financial Stability Review 2011* for the classification of banks. Two additional banks, Agribank Ltd and Ferratum Bank (Malta) Ltd were licenced in 2012 but were not yet operational before the end of 2012.

⁴ Should lending to the Turkish branches be excluded, lending to EU countries would account for 68.5% of the banks' total customer lending.

for 83.3% of total securities. These holdings largely reflect the operations of the two Turkish bank branches. When excluding these two branches, the majority of securities (80.6% of the total) constituted debt issued in EU countries. The majority of these bonds were privately issued bonds, whereas no domestic securities were held by this category of banks (see Chart 5.9).

Funding structure

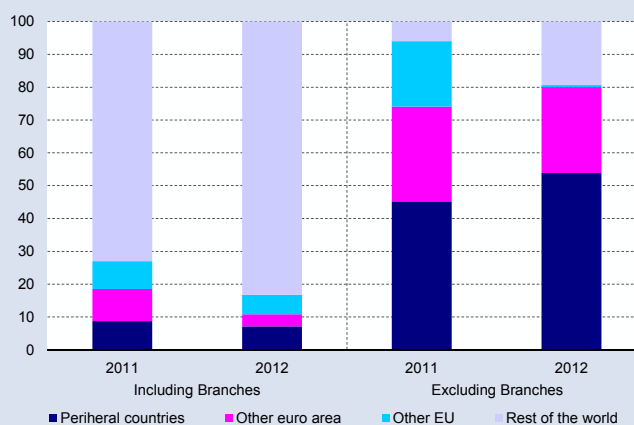
On the liabilities side, international banks primarily obtained their funding from the wholesale market, which accounted for almost 55% of total liabilities (see Chart 5.10).⁵ The interconnectedness to the domestic financial system also remained non-existent, with practically no resident interbank liabilities. Meanwhile, Eurosystem funding remained low at just 0.3% of total assets.

Customer deposits, which are almost entirely obtained from the non-resident market, finance almost 18% of the international banks' balance sheet. Resident deposits remained minimal, amounting to almost €12 million and equivalent to just 0.1% of total resident deposits in Malta. The amount of deposits covered by Malta's Depositor Compensation Scheme represented just 0.5% of the total covered deposits in the Maltese financial system.

Profitability

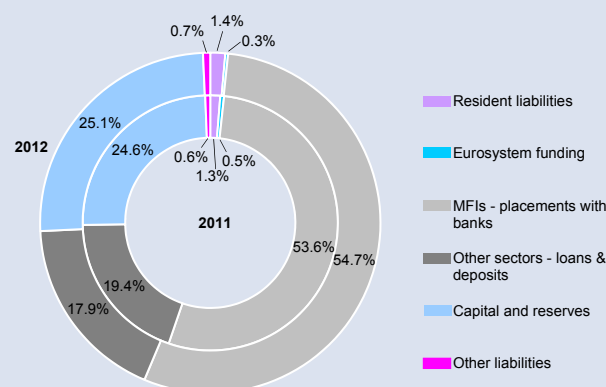
During 2012 international banks reported a 14.7% increase in their pre-tax profits. This improvement was entirely attributable to operations of the branches. Higher net interest income contributed to the improved performance, although this was partly offset by lower non-interest income. The latter resulted from trading losses on foreign exchange dealings. Excluding the performance of the two branches,

Chart 5.9
INVESTMENT SECURITIES BY RESIDENCY - INTERNATIONAL BANKS
(per cent)



Source: Central Bank of Malta.

Chart 5.10
LIABILITIES STRUCTURE - INTERNATIONAL BANKS



Note: The inner circle refers to the liabilities structure in 2011 while the outer circle refers to the liabilities structure in 2012.

Source: Central Bank of Malta.

Chart 5.11
PROFITABILITY - INTERNATIONAL BANKS
(per cent)



Source: Central Bank of Malta.

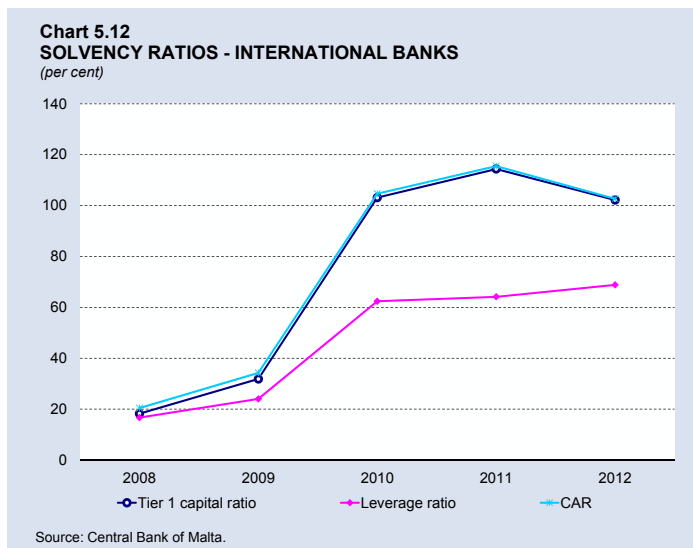
⁵ Wholesale funding relates to deposits, loans and repo agreements with other MFIs.

the profits for the other international banks contracted by 4.9%. In 2012 the ROE and ROA stood at 3.6% and 1.3%, respectively, compared with 3.9% and 1.2% a year earlier (see Chart 5.11).⁶

Solvency and liquidity levels

International banks' solvency ratios remained positive and at elevated levels. As at end of 2012, the CAR stood at 102.7%, whereas the Tier 1 capital ratio was at 102.2% (see Chart 5.12). Such high ratios are largely attributable to one particular bank, which operates with a large deposit base and a corresponding low risk-weighted asset portfolio.⁷

Similarly, the leverage ratio (capital and reserves to assets) also remained healthy, standing at 68.8%. The liquidity ratio, defined as liquid assets to short-term liabilities, comfortably exceeded the minimum requirement of 30%, reaching 146.3% as at end-2012.

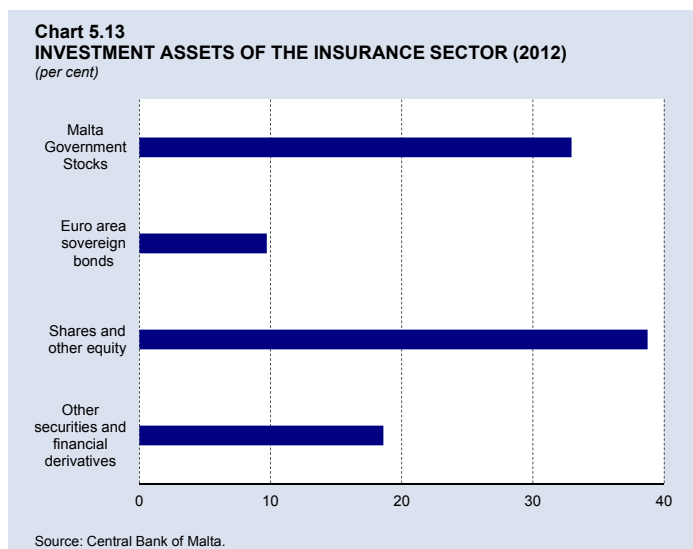


5.2 Insurance and investment funds sector

5.2.1 Domestic insurance companies

The domestic insurance sector comprises three life and five non-life insurance companies. Some domestic insurance companies are closely interconnected with the banking sector, particularly with core domestic banks, as the latter hold a significant shareholding in three of the eight domestic insurance companies (two life insurance companies and one non-life insurance company).⁸ In terms of aggregate assets of the financial sector, the domestic insurance sector remained small, equivalent to only 15.3% of core banks' assets. The high level of concentration continued to persist despite cross-border competition, with one insurance company accounting for more than half of the sector's total assets and almost one third of gross premium written. In fact, the gross premium written for risks in Malta by insurance companies established abroad was minimal.

The investment profile of the insurance sector remained prudent, despite the high level of concentration in the asset structure. Asset allocations were broadly unchanged compared with 2011. The investment portfolio represented 73.2% of the balance sheet value, with domestic sovereign bonds accounting for almost a third of the total investment portfolio (see Chart 5.13). The sector's holding of euro



⁶ The ROE excludes the branches given that these banks do not hold any capital.

⁷ Excluding this particular bank, the Tier 1 capital ratio of the international banks would stand at around 50%.

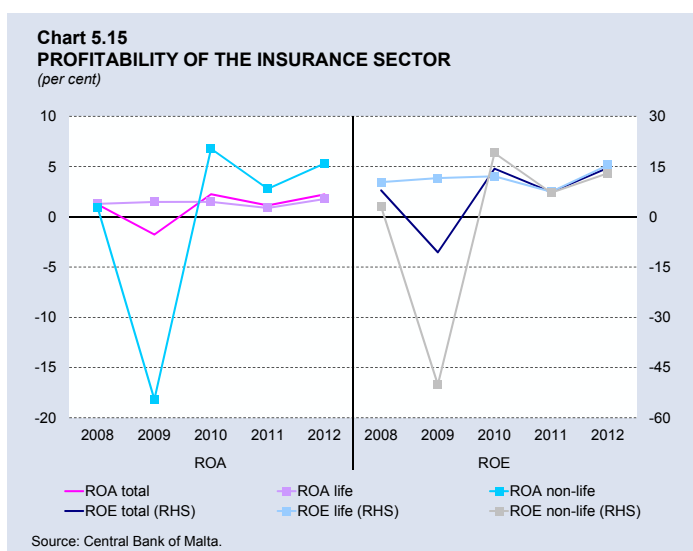
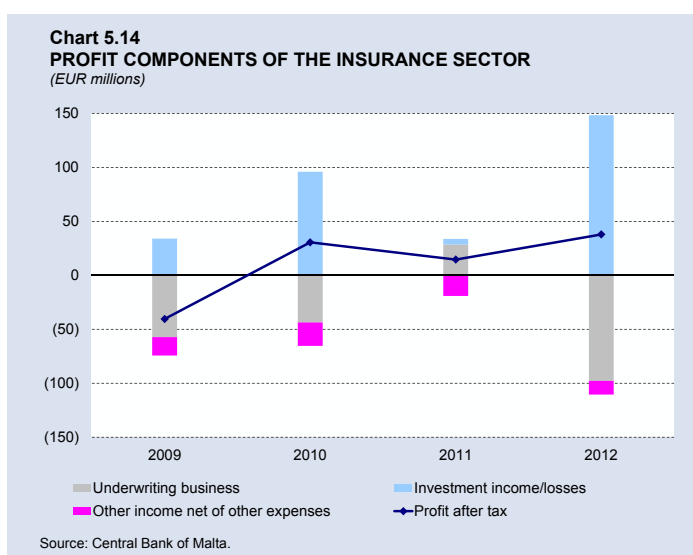
⁸ Refer to *Financial Stability Review 2011* for the categorisation of domestic insurance companies.

area sovereign debt, excluding Malta Government Stocks (MGS), represented 9.7% of the total investment portfolio and did not include any securities from stressed countries. Meanwhile, the proportion of shares and other equity (the majority of which were issued by foreign entities) amounted to 38.7%. Apart from the significant shareholding of core domestic banks in three of the domestic insurance companies, these interlinkages are also evidenced by the fact that around 8.0% of the insurers' total assets consist of deposits held with the banking sector in Malta.

The resilience of the insurance sector continued to be reflected in its profitability figures. During 2012 profits after tax amounted to €37.8 million, more than double than those reported a year earlier (see Chart 5.14). The increase was largely driven by the life insurance sector, although the non-life segment also recorded strong results. The life sector, in fact, reported a considerable improvement in investment income owing to positive market developments, reversing the bleak market conditions of 2011. On the other hand, net premium written declined, mainly owing to a specific large insurance company which reported lower sales of single premium written products. In the case of the non-life sector, both investment income and net premium rose, although the changes were smaller than in the life sector. For most of the non-life insurers, the strong investment returns were reinforced by profitable underwriting activity. This was reflected by the combined ratio of the non-life insurance sector, which stood below 100% at 93.4%.⁹

During 2012 insurance companies reported a general rise in net claims, somewhat dampening profits. This resulted from a greater number of maturity payments during the year compared with 2011, owing to the maturity profile of a tranche of investment-type policies which matured in 2012.

Higher profits pushed up the ROA and ROE to 2.2% and 14.6%, respectively, in December 2012, up from 1.1% and 7.4% a year earlier (see Chart 5.15). The ROE ratio was higher than the average in a sample of large EU insurance groups in the first half of 2012, which hovered around 7%.¹⁰ Such groups reported positive underwriting business and investment income, but were adversely affected by catastrophic events.



⁹ The combined ratio is defined as the sum of net claims incurred and the net operating expenses over the net earned premia. A combined ratio less than 100% signals underwriting profit, as insurers are taking in more in premia than paying out in claims and other expenses.

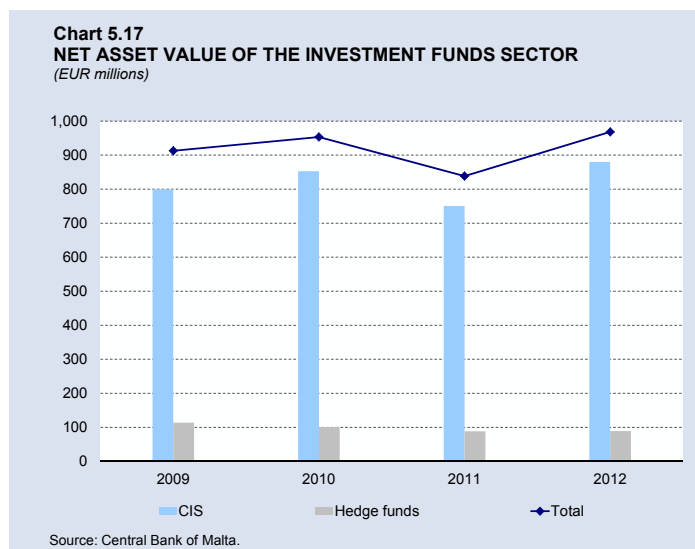
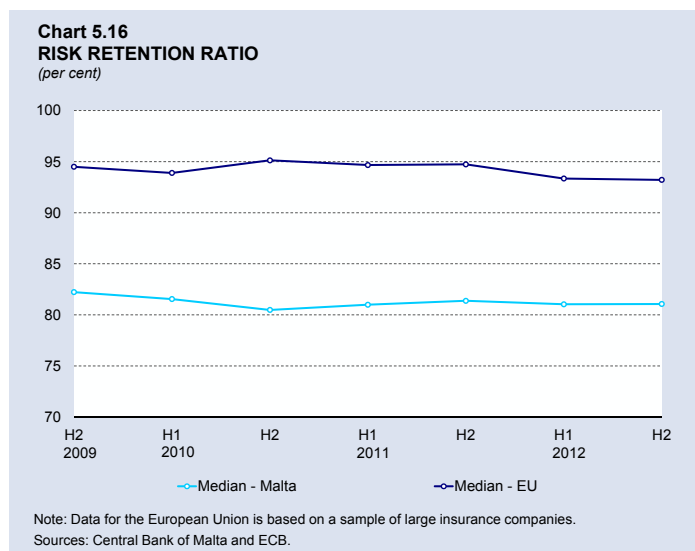
¹⁰ Source: ESRB Risk Dashboard, March 2013.

The capital position of the insurance sector remained broadly stable, supported by prudent distribution policies. At the end of 2012, the ratio of capital to total assets stood at 15.2%, comparable with the median of large insurance companies in the euro area.¹¹ Solvency levels remained higher among the non-life insurers whose business is generally associated with higher risks. The solvency levels of the non-life sector rose to 41.6%, up from 40.9% in 2011, whereas that for life insurers remained stable at 11.5%. Technical reserves, which are set aside by insurance companies to cover future claims, increased by 8.5% on a year earlier.

The risk retention ratio was estimated at 70.3% for the non-life segment and at 95.2% for the life segment.¹² The median risk retention ratio of the aggregate domestic insurance sector stood at 81.1%, relatively lower than the median in a sample of large EU insurance groups, which stood at 93.2% at the end of 2012 (see Chart 5.16).¹³ The insurance sector views the risk of huge claims resulting from catastrophic events as remaining low, as such claims are mitigated through the application of clearly stated exclusion clauses. These exclusions, however, transfer the risk to policy holders and may thus have a potential negative implication for financial stability through the adverse effect on net wealth.¹⁴ Such financial stability implications are, however, deemed marginal.

5.2.2 Domestic investment funds

At the end of 2012, the domestic investment funds sector was composed of 14 funds (ten collective investment schemes [CIS] and four hedge funds).^{15,16} This sector continued to be dominated by core domestic banks, which manage the majority of these funds, or around 98% of the total net asset value. The drop in the net asset value of investment funds reported in 2011 was reversed with an 13.7% rise in 2012, with CIS registering an increase of 15.2%, while the hedge fund category grew marginally (see Chart 5.17). CIS made



¹¹ Source: ECB *Financial Stability Review December 2012*.

¹² The risk retention ratio describes the extent to which gross premia and risk are being retained by the company by netting out premia which are seeded out to re-insurers.

¹³ Source: *ESRB Risk Dashboard, March 2013*.

¹⁴ The United Nation's Institute for Environment and Human Security rates the risk of becoming a victim of a natural disaster in Malta at only 0.72% (the report is based on an index related to the exposure of countries to natural hazards and climate change, as well as social vulnerability). Source: *World Risk Report 2011*.

¹⁵ The Investment Services Act (1994) specifies that CIS are organisations with the aim of collectively investing "capital acquired by means of an offer of units for subscription, sale or exchange". Hedge funds are a special class of CIS, attracting persons or companies with a relatively higher initial level of capital. As their nature is non-retail, hedge funds are subject to limited regulation and oversight.

¹⁶ Refer to *Financial Stability Review 2011* for the categorisation of domestic investment funds.

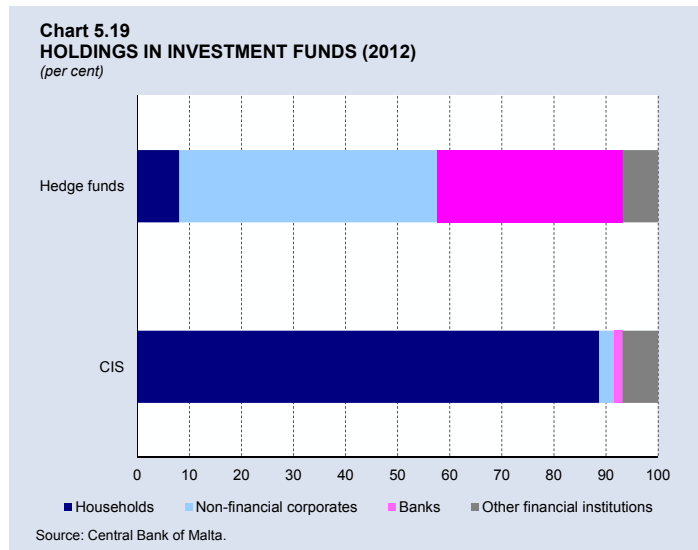
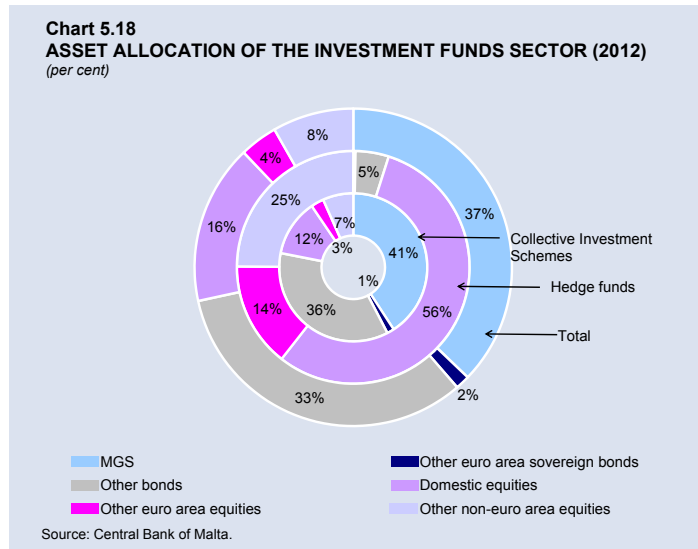
up the bulk, or 90.8%, of the net asset value of the investment funds sector, with hedge funds accounting for just 9.2%.

The expansion in the net asset value was primarily attributable to improved asset valuations, reflecting to a certain degree improvements in international financial markets and the stronger performance of the domestic sovereign securities. The latter accounted for over 37% of the sector's investment assets (see Chart 5.18). The proportion of domestic sovereign debt is more prominent in the case of CIS, equivalent to 40.8% of the sector's investment portfolio, while hedge funds had no holdings in MGS. In turn, the share of holdings of sovereign euro area bonds was limited to only 1.6% for CIS, whereas hedge funds' holdings were almost negligible.

Equity holdings dominated the asset portfolio of hedge funds. These remained skewed towards shares quoted on the MSE, with the latter accounting for some 56% of the hedge funds' total investment assets. Bank equity represented the bulk of such shares, highlighting the strong interconnectedness between the investment funds sector and the banking system. CIS' equity holdings amounted to 21.9%

of their portfolio, equally made up of both bank and non-bank domestic equities. On the other hand, direct exposure to commercial property by the investment funds sector was negligible.

During 2012 there were no particular changes in the interlinkages between the investment funds sector and the banking system in Malta, although these remained high. Nevertheless, the systemic relevance of the domestic investment funds sector was limited, particularly as CIS account for just 5.8% of household financial wealth, despite households being the major fund holders (see Chart 5.19). In the case of banks, these held an average of 4.8% of domestic investment funds (constituted of 1.7% of CIS and of 35.6% in hedge funds). Such fund holdings are equivalent to merely 0.1% of the banking sector's aggregate assets.



6. RISK OUTLOOK AND RECOMMENDATIONS

Despite the difficult external environment, the Maltese economy continued to show a high degree of resilience, which was reflected in a positive rate of growth during 2012. The financial system too maintained its stability in challenging conditions, as risks highlighted in the previous edition of the *Financial Stability Report* and its *Update* remained contained.

Challenges from the international environment

Throughout the year global economic conditions remained weak, amid signs of an easing of pressures in international financial markets towards the end of the year. The uncertainty across the euro area persisted, with the economy in this region contracting by a larger extent than anticipated. The negative feedback loops between sovereigns and the banking sector emerged in the early part of 2012; however, these stabilised towards the end of the year. Strains in financial markets re-appeared briefly in the first quarter of 2013 in response to the banking crisis in Cyprus. As a result, the focus of market attention turned on small countries with relatively large banking sectors. In this regard, therefore, it is relevant to highlight some figures which throw further light on Malta's banking structure.

At end-2012, the banking sector in Malta consisted of 26 credit institutions with total assets amounting to almost 800% of gross domestic product (GDP).¹ However, assets belonging to the five core domestic banks, which are extensively integrated with the domestic economy, accounted for 218% of GDP, while assets belonging to the eight non-core banks, which undertake a very low volume of business with the domestic economy, accounted for 77% of GDP. The rest of Malta's banking sector is made up of 13 international banks with very limited links to the domestic economy and to the rest of the financial sector. These banks hold assets totalling 494% of GDP.

Furthermore, core, non-core, and international banks are all well-capitalised, highly liquid and profitable. The core banks' capital adequacy ratios increased from 13.5% in 2011 to 14.3% in 2012, well above the 8% threshold. The Tier 1 capital ratio also improved from 9.6% in 2011 to 10.3% in 2012, again well above the regulatory minimum of 4%. In the case of non-core and international banks, the capital adequacy ratios were also significantly in excess of the regulatory requirements at 29.1% and 102.7%, respectively. In 2012 banks reported healthy profits with the return on equity remaining at a high level, with that for core domestic banks standing at 23.9% while for non-core banks at 6.5% and 3.6% for international banks. All banks had ample liquidity levels well above the 30% requirement as liquid assets to short-term liabilities also stood at 49.1%, 82.4% and 146.3% for core, non-core and international banks, respectively, in 2012.

Another aspect of the banking sector in Malta is that a significant proportion of assets are held by foreign-controlled subsidiaries and branches, reflecting efficient cross-border specialisation. Assets belonging to subsidiaries and branches of European Union (EU) banks amounted to more than 250% of GDP, of which about 155% belonged to subsidiaries of globally systemic institutions. A further 363% consisted of subsidiaries and branches of non-EU banks.

Challenges within the financial sector in Malta

Against the prevailing background of uncertainty in international financial markets, the domestic banking sector remained sound and robust during 2012, supported by its prudent business models. This notwithstanding, the banks continue to face a number of challenges, particularly their exposure to specific economic sectors, primarily the construction sector, which still faces difficult business conditions. Looking ahead, modest economic growth may impinge on the performance of creditors, particularly corporates, which could, in turn, adversely affect the associated credit risk of banks. In this regard, banks were urged to continue to maintain moderate loan-to-value ratios, particularly with respect to lending secured by real estate. They were also encouraged to further strengthen their provisioning levels, moderate their forbearance practices and take the necessary steps to reduce the amount of non-performing loans (NPL). The continued adoption of conservative collateral valuations through the allocation of appropriate haircuts was also advocated, particularly

¹ Two additional banks were licensed in 2012 but were not yet operational till the end of 2012.

where loans were covered by commercial real estate since these are more susceptible to general economic or industry-specific shocks. As a policy measure, the Joint Financial Stability Board, which was established in January 2013, started to consider possible enhancements to the Malta Financial Services Authority Banking Rules, particularly BR/09/2008 - Credit and Country Risk Provisioning by Credit Institutions Authorised Under The Banking Act 1994, and BR/12/2013 - The Supervisory Review Process Of Credit Institutions Authorised Under The Banking Act 1994, with a view to strengthening banks' provisioning levels and enhancing capital buffers.

Banks remained highly liquid during 2012, with liquidity ratios well above the regulatory requirements. Thus, liquidity risks are expected to remain contained as banks continue to rely on customer deposits as the main source of funding. Deposits continued to grow during 2012 reflecting households' high propensity to save. On the other hand, given the short-term maturity profile of customer deposits, banks could face some challenges in meeting the new requirements under the CRD IV, as these place greater emphasis on stable long-term funding. Banks will therefore be obliged to adjust their liability maturity structure to comply with the new framework.² In this regard, however, the banks are already taking steps to satisfy the new regulations and it is anticipated that they will be in line with the new requirements before the target date.

While banks are expected to remain profitable, underpinned by generally stable levels of net interest income, the general interest rate environment and regulatory requirements to lengthen deposit maturity structures may have slightly negative implications for the banks' short-term profitability. Furthermore, credit demand may be expected to expand at a decelerating rate in response to modest economic growth. With regard to non-interest income, this was largely affected by international financial conditions, resulting in asset price fluctuations, and hence valuation gains and losses. Given the more stable conditions in international financial markets, it is expected that fluctuations in trading profits will be more restrained.

The banks maintain capital adequacy ratios well above the required regulatory minimum and have been successful in raising capital from external sources. However, a further strengthening of the banks' capital base may be necessary to buttress capital buffers. This could be generated through internal sources. Consequently, banks were encouraged to maintain prudent dividend policies.

Risks from other categories of the banking sector, that is the non-core and international banks, are anticipated to remain low. The operations of these institutions are expected to remain broadly unchanged over the medium term. While some of the non-core domestic banks have increased their resident deposit base, such deposits still constitute only around 6% of total resident deposits in Malta. Non-core domestic and international bank deposits covered by the Depositor Compensation Scheme stood at 6.2% and 0.5% respectively, of total eligible deposits.³

Other sub-sectors of the financial sector, namely, the insurance and investment fund sectors, appear to pose limited risk to the financial system as a whole, although close linkages exist between core domestic banks and individual institutions in these sub-sectors. The generally strong profit performance of insurance companies and investment funds and the adoption of prudent business practices are important elements contributing to the resilience of the financial sector.

Challenges outside the financial sector in Malta

The recent crisis within the euro area revealed the potential adverse link between sovereigns and the financial sector, highlighting the need for sound fiscal policies as a precondition for financial stability. Looking ahead, close adherence to fiscal targets by the Government remains an important condition for stability both in the domestic economy and in the financial sector.

² The new CRD IV regulatory framework introduces two liquidity ratios, namely the Liquidity Coverage Ratio (LCR), which comes into force in 2015, and the Net Stable Funding Ratio (NSFR), which comes into force in 2018.

³ By virtue of Legal Notices Number 159 and 340 of 2012, all banks were obliged to increase their contribution to the DCS from the current level of 0.77% of eligible deposits to 0.846% in 2012; to 0.89% in 2013; to 0.966% in 2014 and 1% by 2015. The Supplementary Contribution (cash contribution) was raised from 0.1% to 0.2% while the Special Contribution (pledged assets) was increased from 0.67% to 0.8%.

An important development in the coming year will be the introduction of the Single Supervisory Mechanism. Thus, as from 2014, the banking sector will start operating under a new regulatory landscape, with the European Central Bank (ECB) taking on increased responsibilities to supervise banks in the euro area. The ECB shall carry out its tasks, subject to and in compliance with the relevant legislation and the common rules and regulations applying to all Member States. While this new regulatory framework is not expected to change the operations of banks in Malta, banks may face increased reporting obligations and more demanding euro area-wide supervisory practices.

The *Financial Stability Report 2012* has emphasised that the external environment continues to be characterised by weak economic conditions and fragility in international financial markets. In a local context it views the macro-financial environment as challenging and thus recommends that core banks continue to adopt prudent lending policies, especially as economic growth is projected to remain modest. The *Report's* main policy recommendations therefore focus on credit risk, concentration risk and the need to restructure balance sheets so as to fulfil the new regulatory requirements (See Table 6.1). The Report notes that measures in line with these recommendations are being gradually implemented by the respective authorities and by the industry participants themselves.

Table 6.1
MEASURES TO ADDRESS KEY RISKS IN THE FINANCIAL SYSTEM

Risks	Measures required	Time horizon
Credit risk	Improve coverage of NPLs	<i>Short term</i>
Concentration risk	Increase capital buffers	<i>Medium term</i>
Regulatory changes (CRD IV)	Lengthen the maturity structure of deposit liabilities	<i>Short term</i>
	Enhance capital buffers through increased profit retention	<i>Medium term</i>

APPENDIX AND GLOSSARY

Appendix: Financial Soundness Indicators

COMPARATIVE INDICATORS 2009 - 2011 - (ALL FIGURES IN %)

	Core domestic banks			Non-core domestic banks			International banks			Total banks		
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
Core FSIs												
Regulatory capital to risk weighted assets	12.89	13.53	14.31	29.77	29.08	29.06	104.70	115.53	102.67	54.64	56.78	53.35
Regulatory Tier 1 capital to risk-weighted assets	9.17	9.55	10.28	27.93	27.35	25.91	103.12	114.38	102.18	52.06	54.22	50.93
Non-performing loans net of provisions to capital	55.86	54.45	56.19	9.81	8.92	8.00	0.43	0.08	0.16	6.92	6.76	7.47
Non-performing loans to total gross loans	7.45	7.33	8.09	3.59	4.47	4.12	0.61	0.45	0.49	3.04	3.25	3.74
Sectoral distribution of loans to total loans												
Agriculture	0.31	0.30	0.29	0.06	0.07	0.07	0.00	0.00	0.00	0.11	0.11	0.12
Fishing	0.13	0.12	0.12	0.00	0.00	0.00	0.00	0.00	0.00	0.04	0.04	0.05
Mining and quarrying	0.10	0.08	0.08	0.07	0.01	0.01	0.00	0.00	0.00	0.04	0.03	0.03
Manufacturing	3.48	3.30	3.86	0.29	0.34	0.36	0.00	0.00	0.00	1.13	1.21	1.52
Electricity, gas, Steam and Air Conditioning Supply	5.50	5.70	5.37	0.09	0.10	0.11	0.00	0.00	0.00	1.76	2.06	2.09
Water Supply; Sewerage waste management and remediation activities	0.78	0.76	0.79	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.27	0.30
Construction	12.92	12.09	11.17	3.96	4.57	4.17	0.00	0.00	0.00	4.46	4.72	4.67
Wholesale and retail trade; Repair of motor vehicles and motor cycles	10.19	9.91	9.40	0.64	1.22	1.79	0.00	0.00	0.00	3.30	3.67	3.79
Transportation and storage	4.60	4.63	4.36	1.05	1.08	0.95	0.04	0.05	0.00	1.58	1.78	1.77
Accommodation and food service activities	5.54	5.50	5.50	0.23	0.10	0.12	0.00	0.00	0.00	1.79	1.99	2.14
Information and communication	1.45	1.37	1.33	0.04	0.06	0.09	0.00	0.00	0.00	0.47	0.50	0.52
Financial and insurance activities	2.21	2.12	2.11	0.19	0.39	0.23	0.00	0.00	0.00	0.72	0.80	0.84
Real estate activities [includes imputed rents of owner-occupied dwellings]	4.17	4.05	4.03	2.80	3.13	3.04	0.00	0.00	0.00	1.57	1.71	1.82
Professional, scientific and technical activities	0.85	1.05	0.89	0.05	0.06	0.04	0.00	0.00	0.00	0.28	0.38	0.27
Administrative and support service activities	1.11	1.13	1.08	0.46	0.52	0.51	0.00	0.01	0.01	0.39	0.45	0.46
Public administration and defence; Compulsory social security	1.49	1.47	1.49	0.00	0.00	0.01	0.00	0.00	0.00	0.47	0.53	0.58
Education	0.31	0.41	0.43	0.00	0.00	0.00	0.00	0.00	0.00	0.10	0.15	0.17
Human health and social work activities	0.47	0.54	0.64	0.00	0.28	0.27	0.00	0.00	0.00	0.15	0.22	0.27
Arts, entertainment and recreation	0.48	0.51	0.73	0.34	0.36	0.32	0.00	0.00	0.00	0.18	0.21	0.31
Other Services activities	0.34	0.36	0.38	0.02	0.03	0.03	0.00	0.00	0.00	0.11	0.13	0.15
Households and individuals (excl. Sole Proprietors)	41.94	42.95	44.39	0.67	0.75	0.81	0.00	0.01	0.01	13.42	15.52	17.23
Activities of extraterritorial organisations and bodies	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Non-resident	1.63	1.65	1.76	89.02	86.94	87.09	99.95	99.94	99.98	67.69	63.51	60.91
Return on assets	1.40	1.27	1.63	1.33	0.48	1.51	1.10	1.16	1.25	1.20	1.12	1.38
Return on equity	22.38	19.46	23.93	4.35	1.37	7.01	3.08	3.89	3.61	5.00	5.09	5.95
Interest margin to gross income	70.66	72.46	66.80	63.39	69.96	28.52	62.05	89.00	124.61	66.01	79.11	83.05
Non-interest expense to gross income	49.66	54.07	45.52	35.45	45.53	28.85	8.18	8.87	7.08	30.02	34.10	27.48
Non-interest income to gross income	29.34	27.54	33.20	36.61	30.04	71.48	37.95	11.00	-24.61	33.99	20.89	16.95
Liquid assets to total assets	24.93	24.09	28.83	10.86	14.74	14.41	5.76	7.39	9.94	15.09	16.11	19.67
Liquid assets to short-term liabilities	42.85	44.10	49.09	82.86	90.40	82.43	86.13	111.02	146.27	47.83	49.59	55.63
Other FSIs												
Coverage ratio	19.83	19.76	22.10	31.73	42.84	40.93	76.00	107.67	96.41	27.72	29.16	29.04
Domestic investment securities to total assets	12.28	12.76	11.95	2.23	2.23	2.88	0.00	0.00	0.00	3.55	3.77	3.59
Foreign investment securities to total assets	11.90	11.46	10.73	35.13	36.10	38.27	28.75	31.50	36.52	24.81	26.37	29.56
Unsecured loans to total lending	20.02	19.79	22.42	54.69	39.48	50.74	56.05	54.24	57.80	44.46	40.64	43.52
Assets to total capital and reserves (*)	15.78	15.48	14.55	4.12	4.21	4.89	1.60	1.56	1.45	3.13	3.13	3.14
Large exposure to capital	144.86	138.48	122.44	72.86	131.21	111.67	6.43	10.25	10.95	25.45	32.22	31.54
Gross asset position in financial derivatives to capital	2.18	4.89	3.20	0.68	1.51	0.55	0.00	0.42	0.55	0.68	0.99	0.87
Gross liability position in financial derivatives to capital	7.88	11.56	10.76	1.06	2.45	2.66	0.10	0.12	0.07	0.99	1.55	1.54
Personnel expenses to non-interest expenses	55.61	52.44	53.98	34.52	36.24	37.23	19.41	21.24	26.70	48.09	46.50	48.19
Customer deposits to customer loans	141.74	137.51	142.66	38.16	55.70	68.82	81.94	71.93	76.10	102.58	99.78	68.82
Net open position in equities to capital	16.07	17.74	17.31	80.38	79.71	75.43	0.89	0.89	0.06	7.49	7.68	7.51

(*) expressed as a ratio.

Glossary

Capital adequacy ratio: the bank's regulatory capital expressed as a percentage of its risk-weighted assets.

Collective provisions: the amount of provisions allocated for the estimated losses incurred on a collective basis, but which have yet to be individually identified.

Combined ratio: as the sum of net claims incurred and the net operating expenses over the net earned premia. A combined ratio less than 100% signals underwriting profit, as insurers are taking in more in premia than paying out in claims and other expenses.

Core Tier 1 capital ratio: Tier 1 capital is the core measure of a bank's financial strength from a regulator's point of view. It is composed of core capital, which consists primarily of common stock and disclosed reserves (or retained earnings), but may also include non-redeemable non-cumulative preferred stock. The Basel Committee also observed that banks have used innovative instruments over the years to generate Tier 1 capital; these are subject to stringent conditions and are limited to a maximum of 15% of total Tier 1 capital.

Coverage ratio: the stock of specific and collective provisions expressed as a proportion of non-performing loans.

Credit default swap: a swap designed to transfer the credit exposure of fixed income products between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the creditworthiness of the product. Thus, the risk of default is transferred from the holder of the fixed-income security to the seller of the swap.

Customer deposits: all currency deposits of (i) money market funds (ii) central government (iii) other general government and (iv) other remaining economic sectors, excluding the financial intermediation sector.

Customer loans: all currency loans of (i) money market funds (ii) central government (iii) other general government and (iv) other remaining economic sectors, excluding the financial intermediation sector.

Depositor Compensation Scheme: a rescue fund for depositors of failed banks which are licensed by the Malta Financial Services Authority.

Interest burden: all interest payments excluding repayment of principal.

Leverage ratio: the proportion of capital and reserves/shareholders' funds to balance sheet assets. Capital and reserves/shareholders' funds include ordinary shares, share premium, perpetual preference shares, reserves and capital contributions.

Liquid assets: consist mainly of cash and balances held with the Central Bank of Malta, Treasury bills and similar securities, other eligible bills, deposits held with other credit institutions, debt securities, gold and other bullion, and investment funds.

Liquidity ratio: the value of liquid assets to short-term liabilities. In terms of Banking Rule BR/05/2007 issued by the MFSA, credit institutions are required to hold a minimum liquidity ratio of 30%.

Loan loss provisions: collective provisions and specific provisions.

Loan-to-deposit ratio: the statistic for assessing a bank's liquidity by dividing the banks total loans by its total deposits. This number, also known as the LTD ratio, is expressed as a percentage. If the ratio is too high, it means that banks might not have enough liquidity to cover any unforeseen fund requirements; if the ratio is too low, banks may not be earning as much as they could be.

Loan-to-value ratio: the amount lent for the purchase of a property expressed as a proportion of the value of the property purchased.

Net impairment charges: costs incurred as a result of the decline in the value of assets. These include write-down of loans, investments and non-financial assets, net of recoveries and reversals.

Non-performing loans: credit facilities with payments of interest and/or capital overdue by 90 days or more, as well as those facilities about which a credit institution has reason to doubt the eventual recoverability of funds.

Non-performing loans ratio: non-performing loans expressed as a percentage of total loans outstanding.

Probability of default: the likelihood that a debt will not be paid on time.

Repurchase agreement (repo): contract of sale of securities accompanied by an agreement authorising the seller to buy back the securities at a later date.

Return on assets: annual net income before tax divided by a 12-month average value of total assets.

Return on equity: annual net income before tax divided by a 12-month average value of shareholders' funds.

Risk retention ratio: the proportion of risk which is retained within insurance companies and is defined as premia written, net of reinsurance, as a proportion of gross premia.

Risk-weighted assets: assets multiplied by their respective risk weights as specified in the Capital Requirements Directive.

Short-term liabilities: include the amounts owed to banks and customers, which are withdrawable on demand or at short notice with a remaining time to maturity of three months or less, or which can be withdrawn at any time against a penalty; they also include any other borrowing which is repayable either on demand or with a remaining term to maturity of seven days or less but exclude intragroup borrowings.

Specific provisions: provisions set aside for doubtful/loss facilities. Specific provisions should at least be equal to the loss not covered by collateral in the event of default.

Systemic risk: "the risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy", as defined by the ESRB.

Switch Auction Programme: a voluntary programme launched by the Maltese Government late in 2011 to convert MGS maturing in the short-term into securities with longer maturities.

Technical reserves: the funds set aside by insurance companies from profits to cover claims.

Tier 1 capital: the bank's core capital mainly composed of equity capital and disclosed reserves.

Tier 1 capital ratio: Tier 1 capital as expressed as a percentage of risk-weighted assets.

Tier 2 capital: includes, *inter alia*, undisclosed reserves, revaluation reserves, general provisions and subordinated term debt.

Weighted average interest rate: the interest rate charged to each economic sector multiplied by the latter's share of total outstanding loans.