Financial Stability Report 2011

BANK ĊENTRALI TA' MALTA
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FOURTH FINANCIAL STABILITY REPORT

2011

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ABBREVIATIONS

BLS	Bank Lending Survey
BR	Banking Rule
CAR	Capital adequacy ratio
CBOE	Chicago Board of Exchange
CDS	Credit default swaps
CIS	Collective Investment Scheme
CRD	Capital Requirements Directive
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EFSF	European Financial Stability Facility
EIOPA	European Insurance and Occupational Pensions Authority
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
EU	European Union
FSI	Financial soundness indicator
GDP	Gross domestic product
ICT	Information and communications technology
IMF	International Monetary Fund
LR	Loss rate
LTRO	Long-term refinancing operations
LtV	Loan-to-value
MEPA	Malta Environment and Planning Authority
MFI	Monetary financial institution
MHRA	Malta Hotels and Restaurants Association
MGS	Malta Government Stocks
MSE	Malta Stock Exchange
NCB	National central bank
NPL	Non-performing loan
NSO	National Statistics Office
PD	Probability of default
REMS	Real Estate Market Survey
ROA	Return on assets
ROE	Return on equity
UK	United Kingdom
UN	United Nations
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. In this edition of the *Report* a new methodology has been introduced to classify credit and financial institutions. The methodology is explained in a special feature in the *Report*. Thus, 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.

1. OVERVIEW

The local financial system remained resilient during 2011, supported by positive economic growth and low unemployment. In the light of unfavourable international economic conditions, however, financial stability considerations continued to be challenging. The last few months of 2011 were characterised by a stressed international financial market, owing to deterioration in the euro area sovereign debt crisis and its contagion effects, which also impacted on the funding conditions of a number of European banks. Towards the end of the year, however, financial markets tended to stabilise in response to decisions taken at the European Summit of Heads of States, which laid the foundations for a more rigorous system of fiscal governance. The decision by the European Central Bank (ECB) to extend its non-standard credit support facilities to the banking sector, mainly by providing liquidity through new three-year long-term refinancing operations (LTROs), was a further factor contributing to the more stable conditions in European financial markets.

Against this international negative background, the Maltese macroeconomic environment remained supportive of financial stability, with core domestic banks unscathed as they continued to focus on domestically-oriented intermediation activities. Thus, during 2011 bank balance sheets expanded by around 5.2%, with lending transactions contributing to over half of this balance sheet growth. Mortgage and consumer lending registered an increase of 8.6% and 1.2%, respectively, over the previous year while lending to the corporate sector increased by 2.6%. Funding and liquidity levels remained robust, with customer deposits being the main source of funding for core domestic banks, though growing at a slower pace of 1.4% when compared with previous years. The main sources of funding remained strong throughout the year with an improvement in maturity patterns and some diversification. Over the year, banks sought higher recourse to intragroup and Eurosystem funding to expand their balance sheets, which, on aggregate, still continued to constitute a very small share of total funding.

With regard to core domestic banks' capital adequacy, this was maintained at well above the regulatory limit of 8% for the Capital Adequacy Ratio (CAR) and 4% for the Tier 1 capital ratio, reaching 13.5% and 9.5%, respectively. The increase in Tier 1 capital was achieved through retained earnings, which, in turn, reflected the core domestic banks' profitable performance in 2011. Higher net interest income and low direct exposures to the debt of the most stressed euro area sovereigns were factors contributing to good profit results for the year. In this respect, it is relevant to highlight risks posed by close interconnectedness between the public and financial sectors, as is the case in many euro area countries where banking institutions hold substantial amounts of government debt. While in the local context such a situation is not preoccupying, it highlights the importance of fiscal sustainability as a pre-condition for financial stability.

During the year, the loss-absorbing quality of the banks' capital remained high as confirmed by the results of stress tests applied by the Central Bank of Malta to core domestic banks. These tests are based on a number of extreme but plausible assumptions relating to asset quality deterioration, an economic downturn, a drop in house prices and persistent deposit withdrawals.

In its assessment of financial stability in Malta, the Central Bank of Malta identifies the level of non-performing loans and the concentration of lending and collateral on property as the main risks from within the financial system. On the other hand, the most significant risk from outside the financial system emanates from the banks' exposure to certain economic sectors experiencing weak business activity, namely construction and real estate.

Credit exposure, primarily to the property market, remains the main source of risk for core domestic banks. Thus, in order to strengthen their resilience in the short term, an increase in provisioning levels is warranted. Furthermore, rescheduling practices should only be applied where the underlying loan quality has remained fully intact. In the longer term, measures should be taken to better diversify the lending portfolio of banks. Ahead of the introduction of more stringent regulatory requirements under the Capital Requirements Directive (CRD) IV, banks are encouraged to strengthen their capital buffers and to continue to lengthen the maturity profile of their liabilities to better match that of their assets.

For the rest of the financial system, the Bank assesses the level of systemic risk as low. Despite its large size, the international banking sector remained largely focused on transactions with non-residents, while non–core domestic banks' links with residents remained limited. Both bank categories maintained high solvency and liquidity ratios. On the other hand, risks and vulnerabilities in the domestic non-bank financial sector remained relatively contained.

Table 1.1
SUMMARY OF RISKS

Main vulnerabilities and risks for the financial system	Type of risk	Change since 2010 FSR	Risk position as at 2011			Risk outlook for 2012
			Moderate	Medium	Elevated	
Vulnerabilities within the financial system						
Increasing amounts of non-performing loans and low level of provisions	Credit	↔			●	↔
Concentration in bank lending and collateral towards property	Credit	↔			●	↔
High proportion of short-term funding	Liquidity	↔	●			↔
Reliance on euro system and US dollar funds	Liquidity	↔	●			↓
Deleveraging resulting in credit crunch	Earnings	↔	●			↔
High risk retention within the insurance sector	Earnings	↔		●		↔
Vulnerabilities outside the financial system						
Subdued growth conditions which may impact on corporate profitability and employment incomes	Credit	↔		●		↑
Weak activity within the construction sector and low property market turnover	Credit	↑			●	↔
Domestic macroeconomic imbalances	Credit, Earnings	↔		●		↔
Negative feedback loop between the public and financial sectors	Earnings	↔	●			↔
EU sovereign debt crisis	Earnings	↑	●			↔
Limited liquidity in the domestic capital market	Liquidity	↔	●			↔
Government refinancing needs	Liquidity	↔	●			↔
Interlinkages between bank and non-bank financial institutions	Contagion	↔	●			↔

2. THE MACRO-FINANCIAL ENVIRONMENT

Throughout the past year the macro-financial environment continued to be characterised by fragility and uncertainty. Risks to financial stability resurfaced across the euro area in 2011 and persisted into 2012. During this period, financial market volatility in the euro area notably increased, as the sovereign crisis deteriorated and its impact on the banking sector rose in an environment of weakening economic growth. Measures to restore confidence and address tensions in financial markets were taken at European Union (EU) level through an agreement on a new fiscal compact and an enhanced European Financial Stability Facility (EFSF). In addition, measures were introduced to boost the capital of European banks and to address bank liquidity needs through European Central Bank (ECB) support.

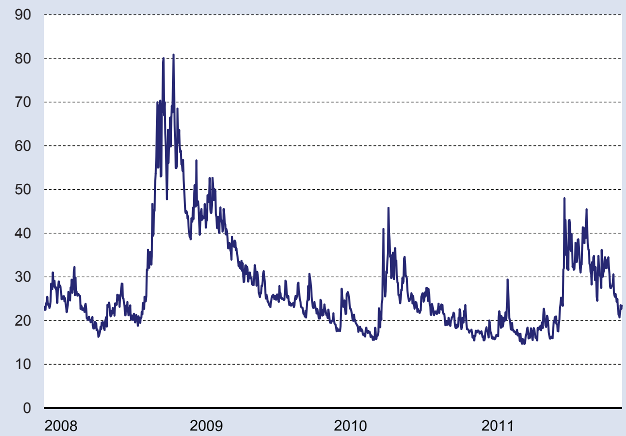
In the near term international macro-financial conditions are likely to remain challenging, as the introduction of a number of fiscal austerity measures and further deleveraging by banks continue to have a negative impact on economic activity. While the latest forecasts by the European Commission (EC) indicate that these factors could translate into a mild recession in the euro area, the amplitude and duration may increase if contagion concerns reappear or policy measures do not yield the desired effect. Looking ahead, some of these tensions may be alleviated as a result of the liquidity support provided by the ECB and the persistent low level of official interest rates. Similarly, the European Council's agreement on stronger fiscal discipline and larger bail-out funds should boost investor confidence in the EU financial system.

Against this macro-financial environment the domestic economy continued to show resilience generally supportive of financial stability. Some downside risks to the macroeconomic outlook should not, however, be overlooked as these could ultimately impact on the asset quality of banks.

2.1 The external environment

International economic conditions were fragile throughout 2011. World economic growth decelerated to 2.9% from 4.3%.[1] Euro area growth was limited to 1.5% while the UK and US economies expanded by 0.8% and 1.7% respectively.[2] Apart from the euro area sovereign debt crisis, other exceptional factors which weighed on global economic growth were the Japanese natural disaster and higher oil prices as a result of political uprisings in the Middle East and North Africa. Oil prices (in US dollars) rose by 16.0% over the year, mainly reflecting the significant upward trend recorded during the first quarter of 2011. Similar price patterns were exhibited by gold, which traditionally serves as a safe haven asset and is a good indicator of risk aversion. The higher level of uncertainty in 2011 lifted gold prices by 10.2%. Equity prices also fluctuated considerably, with standard volatility benchmarks increasing significantly, though still below the levels recorded in the immediate post-Lehman period (see Chart 2.1). Downward pressures on equity prices were more pronounced across banking sector shares, which lost almost one third of their value during 2011 to end

Chart 2.1
CBOE VOLATILITY INDEX - VIX

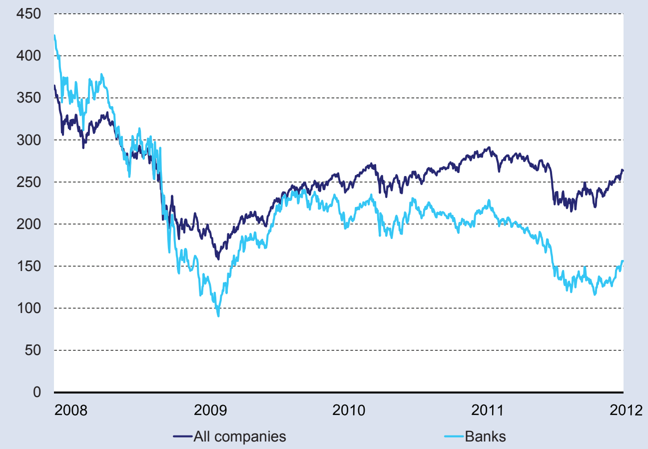


Source: Reuters.

[1] Source: Consensus Forecasts December 2011 and July 2012.
[2] Source: Eurostat.

the year 69% below their end-2007 level (see Chart 2.2).

Chart 2.2
DJ STOXX 600 (EUROPE)

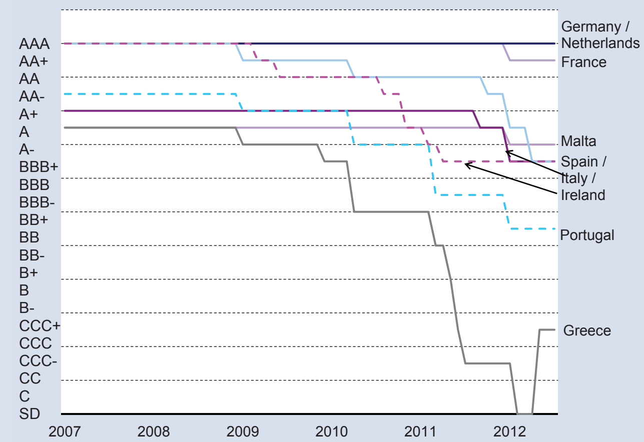


Source: Reuters.

While the higher costs of issuing equity exacerbated the difficulties faced by European banks to strengthen their capital base, the significant interconnections between sovereigns and banks placed both parties under increasing financial market scrutiny during 2011. In the case of euro area sovereigns, the vast majority experienced rising yields and record high credit default swap (CDS) premia on their bonds. As a result, funding flows particularly for the most vulnerable sovereigns (countries with high debt, low growth and high unemployment) dried up, with contagion risk materialising for those banks which were highly exposed to these countries.

The proportion of euro area sovereign debt with CDS spreads exceeding 200 basis points surged to 47% by February 2012 from 5% in April 2010.[3] Against this background, widespread sovereign credit rating downgrades took place, in some cases even by as much as three notches (see Chart 2.3). Some of the highest rated countries also suffered rating downgrades, which, in turn, caused the EFSF to lose its top notch rating. Since several euro area countries face a negative outlook, further downgrades are still possible in the near term; this may continue to have an adverse impact on several European banks, particularly in terms of their funding sources. In the case of Greece, a partial solution to its unsustainable sovereign debt problem was achieved in the early part of 2012, when its private creditors accepted a proposal put forward by EU Heads of State/Government to enter a voluntary bond exchange programme bearing a 53.5% loss on their Greek bond holdings. Greece was meanwhile required to implement the necessary fiscal restraint measures to bring its public finances and debt back onto a sustainable track. Although the placement of Greek sovereign bonds under selective default status effectively rendered such collateral ineligible for ECB refinancing operations, the Eurosystem compensated for the funding shortfall by providing temporary emergency liquidity assistance until the voluntary debt swap programme was finalised, and Greek sovereign bonds could thus again be used as collateral.

Chart 2.3
SOVEREIGN BOND RATINGS



Source: Standard & Poor's.

To further restore confidence in the financial system the ECB took steps to increase the volume of liquidity. It also enhanced and expanded its non-standard measures through an extension of the Securities Market Programme, the purchases of covered bonds, and the provision of

[3] Source: IMF *Global Financial Stability Report* April 2012.

US dollar funding. Other innovative measures included three-year refinancing operations, the widening of the pool of eligible collateral and the lowering of the refinancing rate to 1.0%, and to 0.75% by July 2012. At the beginning of 2012, the ECB also reduced the minimum reserve requirements by 1 percentage point to 1.0% of the deposit base.

Meanwhile, the European Banking Authority (EBA) took steps to strengthen the resilience of 71 European banks by temporarily raising their minimum core Tier 1 capital requirements to 9.0% by end-June 2012. Banks with identified capital shortfalls were also required to boost their capital. To date, most of these European banks have successfully boosted their solvency ratios to the required levels, thus reducing the near-term risk of deleveraging, which nevertheless remains an undermining factor from a longer-term perspective. This is particularly relevant in relation to cross-border activities, since some European banks have expanded their activities driven by a narrow focus on returns on risk-weighted assets. This has created high systemic risk particularly for some eastern European countries, which depend to a large extent on the lending activities of foreign-owned banks.

A number of measures to restore confidence at EU level were also announced in early 2012. A total of 25 EU Member States signed a new fiscal pact to strengthen fiscal discipline through more automatic sanctions and stricter peer surveillance.

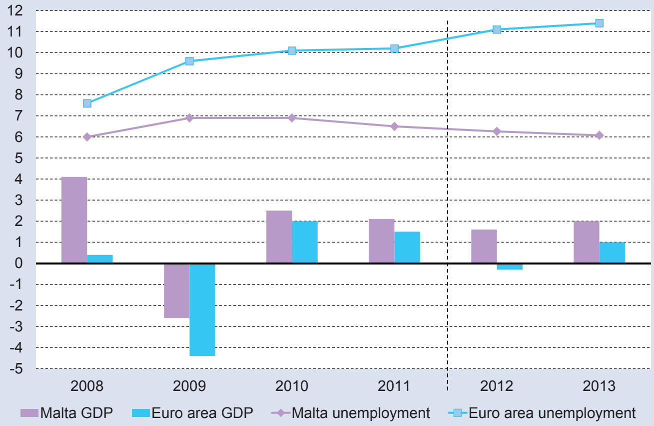
Against this background, the 2012 economic outlook for the euro area continues to be rather challenging. Indeed, euro area real gross domestic product (GDP) is expected to contract by 0.3%, and labour market conditions are projected to worsen, reflecting a further rise in the unemployment rate to over 11.0%.[4] The largest contractions in GDP and the highest unemployment rates are expected to be experienced by the most vulnerable euro area countries. Other euro area countries are, however, still envisaged to register positive economic growth and rather low unemployment rates, similar to what is being projected in the case of Malta. Inflationary pressures across the euro area are in turn expected to decline.

2.2 The domestic environment

Malta's economy remained generally resilient and, as a result, its financial sector continued to expand in a relatively stable condition. Economic growth in 2011 was at 2.1%, some 0.6 percentage point higher than in the euro area (Chart 2.4).

Net exports improved, owing in part to the strong performance of the tourism sector as well as to the ongoing buoyant activities of niche services, such as remote gaming and financial services. Consumption also supported GDP growth, as household disposable income expanded in real terms and unemployment declined. In contrast, private sector investment registered negative growth mainly owing to developments in the energy and transport sub-sectors. The contraction in investment was a major factor contributing to an observed slowdown in domestic credit growth.

Chart 2.4
REAL GDP GROWTH AND UNEMPLOYMENT RATES
(annual percentage changes; per cent)

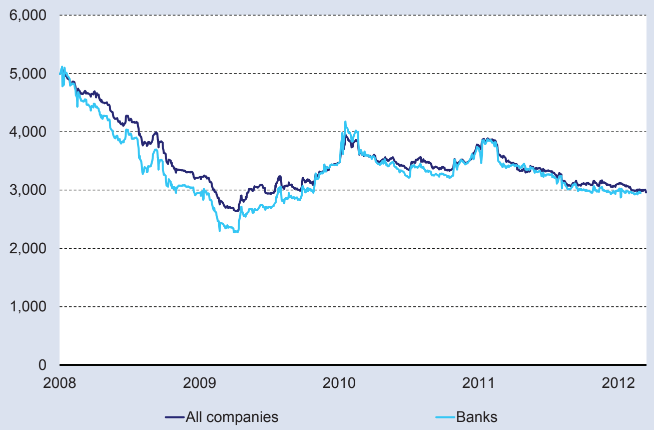


Sources: Eurostat, EC, Consensus Forecasts (July 2012) and Central Bank of Malta.

[4] Source: European Economic Forecast Spring 2012 and Consensus Forecasts July 2012.

As in previous years, some sectors of the economy expanded rapidly, while others lagged behind. Activity within the construction sector, which absorbs a significant share of domestic credit, remained subdued as conditions of oversupply, particularly in some specific segments, persisted. However, house prices proved rather resilient, with the index compiled by the Central Bank of Malta (based on advertised house prices) registering a small rise during 2011. A similar pattern (+1.5% growth) is being projected for 2012, although future corrections in house prices cannot be excluded, particularly as the residential property market is still showing signs of oversupply.

Chart 2.5
MALTA STOCK EXCHANGE INDEX

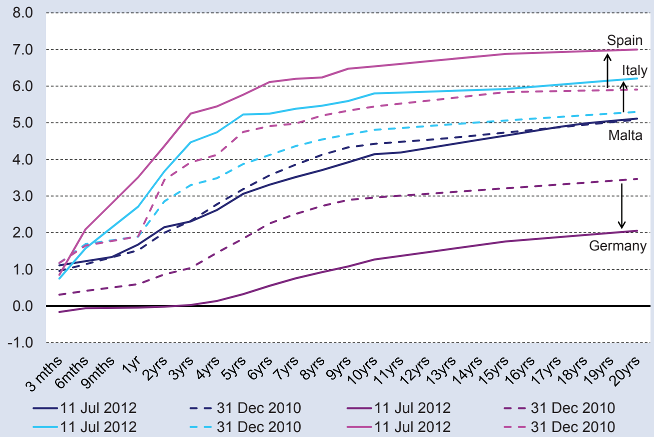


Sources: MSE and Central Bank of Malta calculations.

In 2011 the Malta Stock Exchange (MSE) index dropped by 18.2%, mirroring the drop in the share price of banks which constitute the bulk of market capitalisation (see Chart 2.5). With regard to the payment and settlement systems, these remained robust during the year, enabling smooth transactions involving cash and securities.

In the fiscal area, the public debt-to-GDP ratio increased to 72.0%, while the deficit narrowed to 2.7% of GDP. Forecasts by the Central Bank of Malta suggest that, while the fiscal debt- to-GDP ratio was likely to increase, the deficit ratio would slightly decline. As with most other euro area countries, Malta's sovereign debt credit rating was downgraded by two credit rating agencies but maintained stable by another rating agency.[5] This notwithstanding, the spread on a ten-year government bond vis-à-vis the German bund of the same maturity remained contained as resident investors, who account for 97% of total outstanding Malta Government Stocks (MGS), actively subscribed to new issues of government securities. Thus, the yield curve for MGS remained stable compared with 2011, as yields were unaffected by tensions abroad following the euro area's sovereign debt crisis (see Chart 2.6). Consequently, funding costs for core domestic banks remained stable.

Chart 2.6
YIELD CURVES
(per cent)



Sources: Bloomberg and Central Bank of Malta.

In terms of external competitiveness, the outlook remains generally positive as, since Malta joined the EU, increases in unit labour costs have been comparable with what was observed in the euro area, albeit slightly higher in recent

[5] Since the beginning of 2011 Moody's downgraded Malta's sovereign debt by two notches, from A1 to A3, whereas Standard and Poor's downgraded Malta by one notch from A to A-. Fitch kept its credit rating stable at A+.

quarters. Meanwhile, the country's current account deficit narrowed in 2011. At an average of 4.8% of GDP for the two-year period 2010-2011, the current account deficit largely reflected the profits of foreign-owned firms operating in Malta (recorded as outflows), which were then reinvested as foreign direct investment. Structural unemployment has also tended to remain stable as the country has to-date managed to attract new activities to replace declining industries. The outlook for the Maltese economy in 2012 is mostly subdued given the slowdown in the world economic growth and the negative outlook in the EU.

The risks to financial stability conditions stemming from the macro-financial environment, which characterised developments throughout 2011 and are expected to similarly impact 2012, are analysed in Chapter 3, together with other vulnerabilities arising from within the financial system. In turn, Chapter 4 assesses the resilience of banks to the identified main risks.

3. FINANCIAL STABILITY CONDITIONS

This Chapter considers the main systemic challenges to financial stability in Malta. In this regard it observes that credit risk remained elevated as a result of the repayment weakness of specific borrowers/industries. The concentration towards the property market also adds to this risk. On the other hand, sovereign risk associated with the banks' direct holdings of government debt issued by distressed euro area countries remained insignificant in view of banks' limited holdings. In a local context, however, given the high interconnectedness between public and financial sectors, sustainable public debt dynamics are a necessary condition for financial stability. Meanwhile, the funding ability of core domestic banks remained robust, with very limited reliance on wholesale sources. Liquidity conditions, on the other hand, though generally stable, continued to be characterised by a relatively high volume of demand and short-term deposits. The non-bank financial sector remained resilient, despite recording a weaker performance when compared with the previous year, and its systemic implications were contained, particularly in view of its small size.

3.1 Credit risk

During 2011 the repayment capabilities of some sectors improved. However, credit risks persisted since the construction and real estate sector continued to experience difficulties despite an increased operating surplus. This contributed to a higher level of non-performing loans for core domestic banks.

3.1.1 Credit risk related to the corporate sector

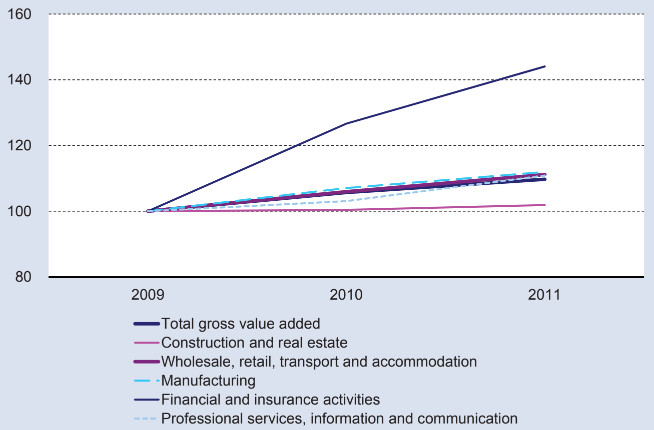
During 2011 the corporate sector recorded a mixed performance with the pace of activity varying across different economic sectors. Most firms maintained their momentum, particularly those involved in pharmaceuticals, ICT, gaming, financial services, and the higher value-added end of the manufacturing sector. On the other hand, enterprises within the construction sector continued to face more difficult business conditions.

In recent years, the gross value added of some sectors grew at a varying pace compared with the average growth of the economy. Since 2009, the financial services industry outpaced the average growth rate of the economy, whereas industries such as professional services, information & communications, manufacturing and wholesale, retail, transport & accommodation sectors kept pace with this average growth rate. The growth rate in gross value added of the construction and real estate industries remained positive over the past three years, but below the average of the economy (see Chart 3.1).

Construction and real estate

According to the latest data issued by the National Statistics Office (NSO) the combined operating surplus of the construction and real estate sectors registered growth of 1.3%. Property prices appeared to have remained stable, with the average year-on-year quarterly growth rates in the Central Bank of Malta's House Price Index slightly positive over the year, with possible increases being anticipated in certain type of dwellings. Despite this generally positive outlook on prices, some downside risks exist as other indicators and information sources suggest that a significant share of enterprises involved in property-related activities were

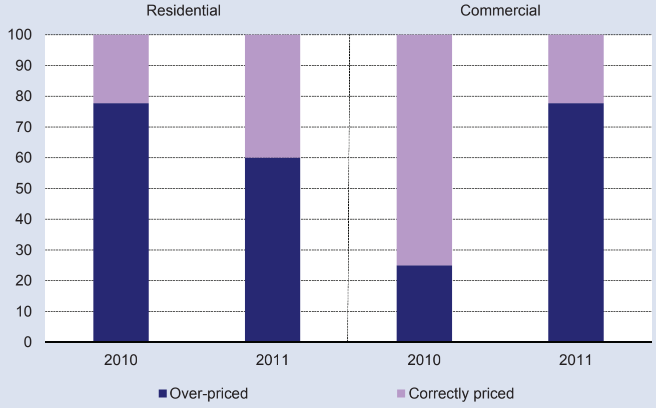
Chart 3.1
INDEX OF GROSS VALUE ADDED – SELECTED SECTORS
(2009 = 100)



Source: NSO.

operating below potential. In fact, according to replies to the Central Bank of Malta's Real Estate Market Survey (REMS) the volume of property sales declined during 2011. The number of respondents perceiving residential properties as overvalued declined in 2011 when compared with 2010, while that of respondents considering commercial properties as being overvalued increased in 2011 (see Chart 3.2). Furthermore, the Construction Confidence Index (published by the European Commission) remained negative and deteriorated throughout 2011, confirming to some extent the negative sentiment in the sector.

Chart 3.2
VALUATION PERCEPTIONS OF RESIDENTIAL AND COMMERCIAL PROPERTIES
(per cent)



Source: Central Bank of Malta Real Estate Market Surveys (December 2010, 2011).

The subdued conditions in the construction and real estate sectors is also evidenced by the number of building permits issued by Malta Environments and Planning Authority (MEPA), which is a leading indicator of future activity. These fell by 11% compared with 2010. In the short term the oversupply conditions may nonetheless still persist, in view of slower mortgage credit growth and the international recessionary environment, which may affect the foreign buyers' market segment.

In view of slower business conditions in the construction and real estate sector, banks have become more cautious in their lending activity vis-à-vis this industry. In fact, in 2011 lending by core domestic banks to construction and real estate activities rose by a marginal 0.7%, while their exposure to the construction and real estate sector continued to account for almost one-third of resident corporate loans.

Other non-financial corporate sectors

The performance across the rest of the corporate sector, which accounts for the remainder of resident corporate lending, varied so that, overall, the weaknesses of specific sectors were compensated for by an improved performance in others. As a result, credit risks associated with the non-property related corporate sector remained rather elevated but stable. Firms involved in wholesale & retail, transportation and accommodation activities registered an increase in their operations. In the case of the tourism sector, results were rather diverse across different market segments. In particular, a hotel industry survey covering 2011 reported an increase in gross operating profit per available room among the 5-star and 4-star hotels but a decline among the 3-star category.[1] The manufacturing sector, meanwhile, recorded an increase in its operating surplus.

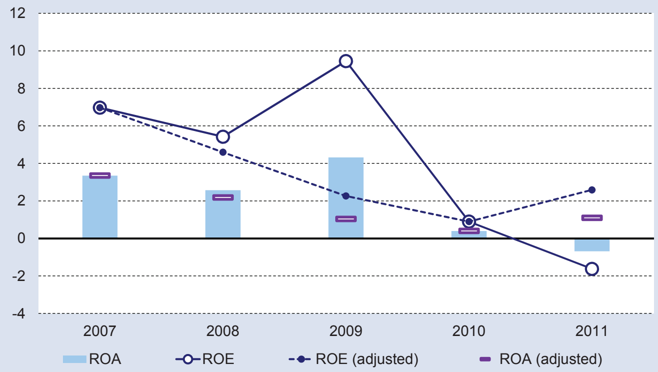
Listed non-financial companies

The specific subset of business groups, which acquired funding from the domestic financial market, performed less positively than a year earlier.[2] The overall return on equity (ROE) and return on assets (ROA) were negative, respectively estimated at -1.6% and -0.7% (see Chart 3.3).[3] However, the underlying performance was somewhat better as, adjusting for exceptional developments, the ROE and ROA were respectively estimated at 2.6% and 1.1%. At a sectoral level, the actual results registered by the construction and real estate, accommodation and food service activities, transport, storage and communication businesses were generally rather negative. Meanwhile, companies involved in the wholesale and retail trade, and in computer and related services reported positive yearly results.

1 Source: BOV MHRA Survey.
2 This group includes those companies which have issued bonds or shares on the Malta Stock Exchange (MSE).
3 Since for a number of companies the full year results were not yet available, the estimates for 2011 were estimated using tailored annualisation methods: in the case of firms whose performances are seasonal, the mid-yearly 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.

The overall sales growth by listed companies increased to 9.0% in 2011 from 5.9% in 2010 driven by the manufacturing, wholesale & retail trade, and computer & related service sectors. However, the accommodation and food service activities, and the transport, storage and communication sectors recorded a deceleration in sales. At the same time, current assets exceeded current liabilities by around 45%, suggesting good liquidity positions. This ratio improved by around 4 percentage points on a year earlier, despite a number of early bond redemptions financed from internal sources. On the other hand, the listed companies' ratio of capital and reserves to total assets remained stable at 30.6%.

Chart 3.3
PROFITABILITY OF LISTED NON-FINANCIAL COMPANIES
(per cent)



Note: The sample of companies was kept consistent throughout the period under consideration. Adjustments to the ROE and ROA relate to extraordinary revaluation gains in 2008 and 2009 and a one-off write-down in 2011.

Sources: MSE and Central Bank of Malta calculations.

Corporate indebtedness and concentration

Lending by the core domestic banks to the resident corporate sector decelerated slightly, to 2.6% in 2011 from 3.4% in 2010.[4] However the slowdown was primarily demand-driven rather than owing to a tightening of lending conditions by commercial banks (refer to Box 1). Momentum in corporate indebtedness was further restrained since no new corporate bond issues were launched during the year under review, in contrast with the previous two years. Indeed, during 2011 a number of outstanding bond issues were redeemed so that at the end of the year the amount of corporate bonds on issue was lower by 0.8%, equivalent to just 6.7% of the total amount of credit extended by core domestic banks. This repayment of bonds was financed through internally-generated cash inflows, higher shareholder loans and additional bank credit.

BOX 1: BANK LENDING SURVEY RESULTS[1]

Credit Supply Conditions

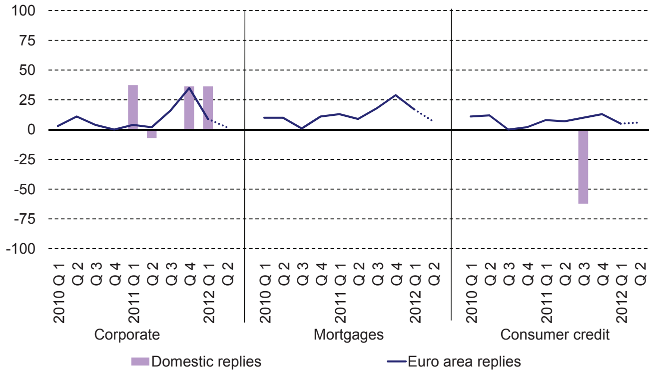
According to the results of the Bank Lending Survey (BLS), in which four of the five core domestic banks participate, the majority of euro area banks continued to tighten their lending standards in 2011, particularly in the second half of the year (see Chart 1). In Malta, credit standards were tightened with respect to the corporate sector; however, in the case of households, they remained generally unchanged. In fact, while mortgage credit standards were stable, some easing was reported for consumer loans, reflecting increased competition for such loans. The tightening in corporate credit standards, on the other hand, was driven by continued uncertain prospects characterising the construction sector, although the downside risks to the general economic outlook also appeared to have had an impact. The restrictive measures mainly took the form of increased collateral requirements and stricter loan

[1] The BLS is the Central Bank of Malta's contribution to the euro area's BLS conducted by the European Central Bank (ECB). The survey in which all National Central Banks (NCBs) of the euro area participate is designed to provide qualitative data on the euro bank loan market on a quarterly basis. Commercial banks providing information to the NCBs are expected to express their views on developments in credit conditions in the previous quarter and their expectations for the subsequent quarter.

[4] A similar pattern was observed for the total banking system, which registered a deceleration to 2.7% from 4%.

covenants. Survey results indicate that stronger competition also appeared to have led some banks to narrow their interest rate margins and to lengthen the maturity periods for loans offered to households. During the first quarter of 2012, credit standards were tightened further for the corporate sector; however, no changes in credit standards are anticipated in the next quarter.

Chart 1
CREDIT STANDARDS
(+ indicates net tightening / - indicates net easing)



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

Sources: ECB and Central Bank of Malta calculations.

Credit Demand Conditions

Throughout 2011, credit demand remained generally subdued both in the euro area and in Malta (see Chart 2). On the domestic front, bank loan officers reported that demand for consumer and corporate credit was generally weak. In the case of mortgage borrowing by households, the demand situation was not clear because quarterly data tended to fluctuate substantially. The banks attributed the weakness in corporate credit demand largely to delayed investments, while in the case of consumer credit this reflected negative consumer sentiment. During the first quarter of 2012, credit demand remained sluggish, with respondent banks not expecting a rebound during the second quarter.

Chart 2
CREDIT DEMAND
(+ indicates increase / - indicates decrease)

Note: Q2 information relate to expectations.

Sources: ECB and Central Bank of Malta calculations.

With the pace of corporate debt accumulation during the year reported as slowing, debt servicing payments on loans and issued securities stabilised and were equivalent to 8.4% of the total operating surplus. Meanwhile, corporate indebtedness dropped to 80.7% in 2011 from 82.5% of GDP in 2010 (see Chart 3.4).[5]

Concentration risk remained somewhat high during 2011 owing to the bulk of bank credit being extended to a subset of large corporate borrowers operating within specific industries. These borrowers, which include firms in the construction and real estate, wholesale and retail, and transport and accommodation sectors, accounted for around one-half of total corporate credit. The dilution of concentration risk

[5] The estimate of corporate indebtedness is based on lending by core domestic banks and outstanding quoted bonds.

in the banks' loan portfolio may be somewhat difficult to achieve in the short term, particularly in a small country. However, lending to the construction sector as a percentage of total resident loans extended by core banks declined by 0.5 percentage point to 12.6% of total resident loans in 2011.

3.1.2 Credit risk related to the household sector

Developments across households were more benign than in the case of the corporate sector but certain vulnerabilities persisted. The level of credit risk associated with households remained low.

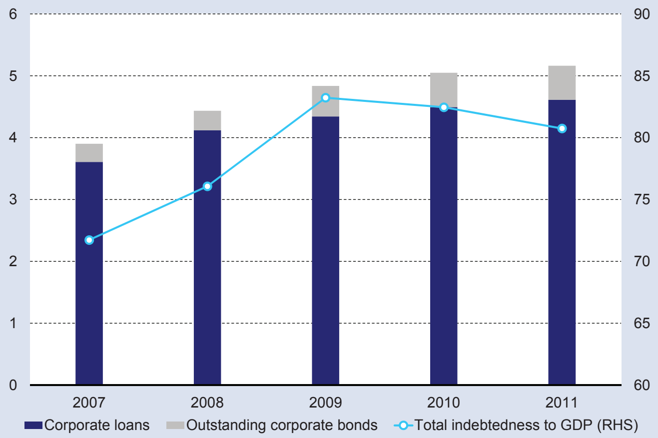
Household indebtedness

Growth in mortgage loans remained buoyant during 2011, rising by 8.6% over the year. On the other hand, consumer credit expanded only marginally by 1.2%, as the economic outlook remained uncertain. Viewed from a longer-term perspective, household credit growth remained significant. During the past three years, mortgage lending expanded at an average annual growth of 6%, while consumer credit rose at an average rate of 1.4% per annum. Thus, at the end of 2011, total household debt as a percentage of GDP increased to 56% from 54.5%, but remained below the level recorded in the euro area (66%).

With household income rising in line with growth in outstanding debt, the interest burden on households remained stable in 2011. Furthermore, the weighted average interest rate on household loans remained constant at 4%, with that for mortgages and consumer credit at 3.6% and 5.7%, respectively (see Chart 3.5).

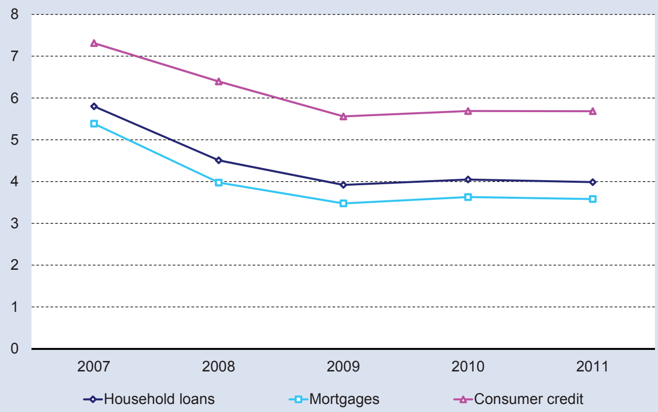
Meanwhile, resident household net financial wealth improved by 2% on

Chart 3.4
INDEBTEDNESS OF NON-FINANCIAL CORPORATES
(EUR billions; per cent)



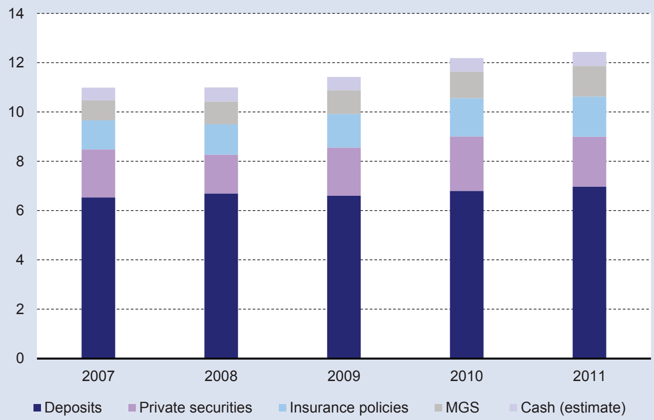
Sources: MSE and Central Bank of Malta.

Chart 3.5
WEIGHTED AVERAGE INTEREST RATES ON RESIDENT HOUSEHOLD LOANS
(per cent)



Source: Central Bank of Malta.

Chart 3.6
GROSS HOUSEHOLD FINANCIAL WEALTH
(EUR billions)



Sources: MSE and Central Bank of Malta.

a year earlier, as higher debt was more than compensated for by a larger stock of deposits and other financial assets (see Chart 3.6).[6]

The risk of higher indebtedness is partially mitigated by the fact that around half of household loans granted during 2011 were channelled to households having an annual income exceeding EUR30,000. An additional 25% of loans were granted to households with an income ranging between EUR20,000 and EUR30,000. The proportion of loans channelled to lower income families (households earning less than EUR10,000 per annum) remained low, accounting for 3% of total loans granted during 2011 (see Chart 3.7).

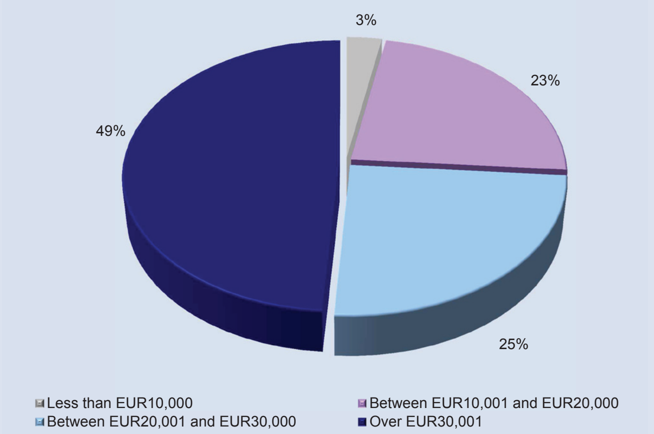
3.1.3 Quality of bank loans

Throughout 2011 the level of insolvencies remained low, while the non-performing loans (NPL) ratio remained stable compared with the previous year, at 7.3% (see Chart 3.8). Quarterly dynamics were uneven, with increases recorded during the first three quarters, and a partial scaling back during the last quarter. The latter, however, mainly resulted from write-offs rather than an improvement in the quality of the loans. The share of non-resident NPLs in total NPLs amounted to less than 1%.

Corporate sector

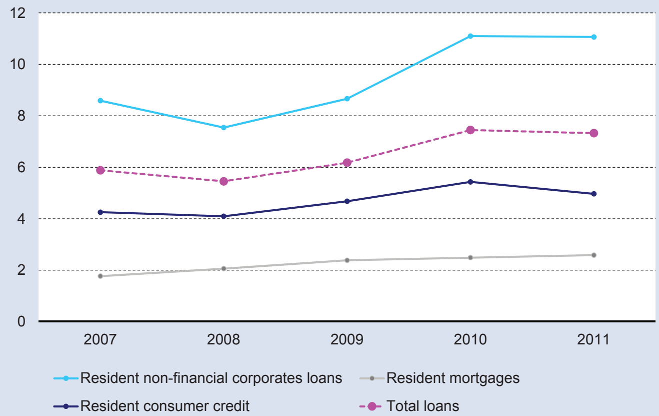
The NPLs of the corporate sector increased marginally by 2.4% in 2011. The pattern of NPLs was, however, divergent across the five core domestic banks, with some actually reporting declines. Despite this increase, the proportion of resident corporate NPLs to total corporate lending remained stable in 2011 at 10.7%, in view of higher loans to the corporate sector. The construction and real estate

Chart 3.7
DISTRIBUTION OF HOUSEHOLD LOANS BY INCOME BRACKET



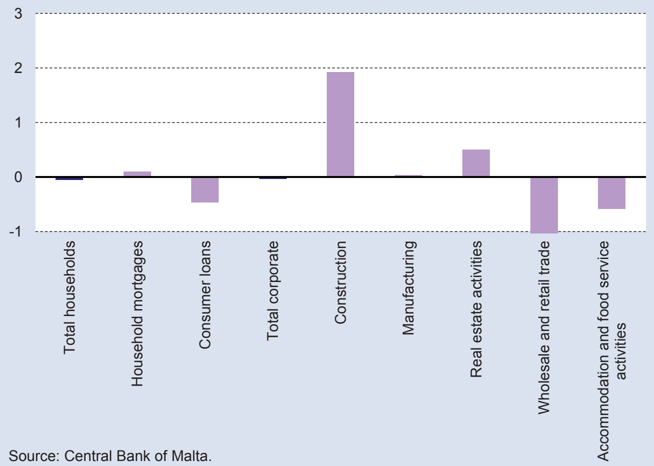
Source: Central Bank of Malta.

Chart 3.8
NPL RATIOS
(per cent)



Source: Central Bank of Malta.

Chart 3.9
CHANGE IN NPL RATIO (2011 COMPARED TO 2010)
(percentage points)



Source: Central Bank of Malta.

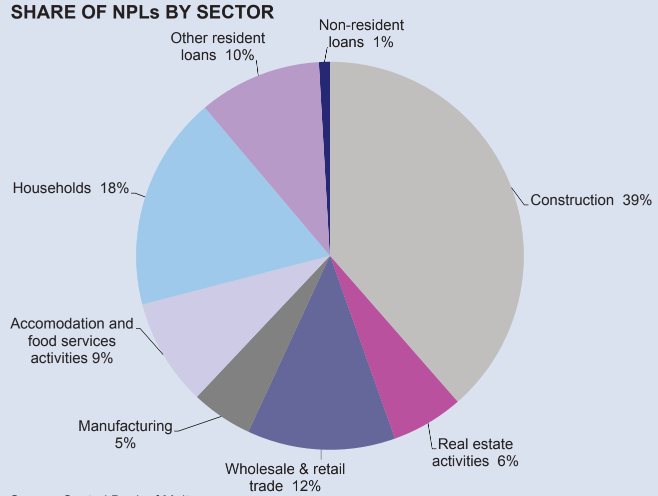
[6] Net financial wealth includes deposits, security holdings, the value of insurance policies and cash, net of borrowings.

sectors experienced increases in their NPLs, whereas other sectors, such as the wholesale and retail trade and the accommodation and food service activities, reported some improvement (see Chart 3.9).

Household sector

The higher quality of household loans, which account for 43.7% of resident loans, was maintained when compared with the corporate sector's loans. The share of household NPLs was equivalent to around 18% of the total (see Chart 3.10).

Chart 3.10
SHARE OF NPLs BY SECTOR



Source: Central Bank of Malta.

Although the quality of mortgage loans deteriorated slightly during 2011, an improvement in the quality of consumer loans partially compensated for it. The overall resident household NPL ratio remained stable at 3%, with the NPL ratio of mortgage loans increasing marginally by 0.1 percentage point, to 2.6% and that of consumer credit declining by 0.4 percentage point to 5.0%.

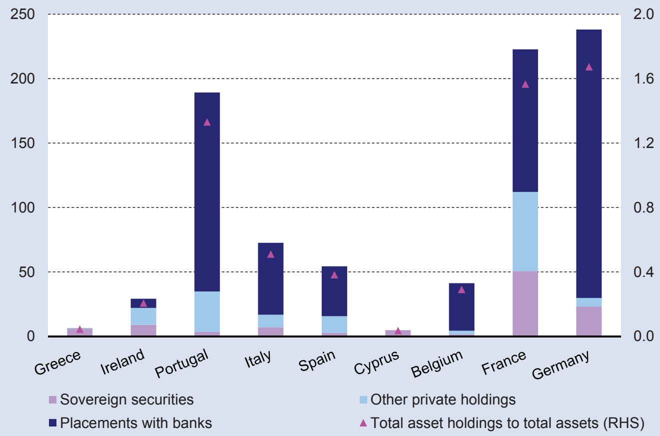
3.2 Euro area asset holdings

Core domestic banks remained resilient to the euro area sovereign debt crisis, despite its intensification during 2011. The banks' linkages to the euro area were mainly in the form of financial assets originating from higher rated sovereign states within the euro area. At the same time, domestic government bonds, which represent another significant proportion of banks' assets, remained unaffected from the turmoil.

3.2.1 Euro area

The aggregate euro area asset holdings of core domestic banks (which include loans, placements with banks and securities relating to the euro area) amounted to an equivalent of 8% of total assets as at the end of 2011, compared with 6% in 2010.[7] From a geographical perspective, such holdings remained diverse and mainly channelled towards strong economies. The majority of euro area holdings are mainly composed of debt and placements with monetary financial institutions and other private companies, while holdings of sovereign bonds issued by the three European Union-International Monetary Fund (EU-IMF) Programme countries remained low (see Chart 3.11).

Chart 3.11
EURO AREA ASSET HOLDINGS OF SELECTED COUNTRIES
(EUR millions; per cent)

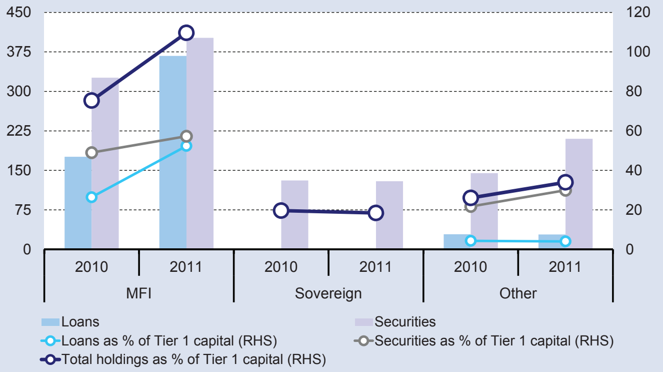


Source: Central Bank of Malta.

[7] Holdings exclude Maltese assets and any holdings with the Central Bank of Malta.

During 2011 euro area holdings rose by 41% in absolute terms, to EUR1.1 billion, but represented only 8% of total assets, up from 6% in 2010. Loans and deposits were the main drivers behind the increase in euro area holdings (see Chart 3.12). These reflected higher placements with monetary financial institutions (MFI), which thus remained a major component accounting for around one-third of total euro area holdings. Securities continued to account for the remaining two-thirds, with a focus on private securities almost entirely in the form of bonds. Of these, 54.2% consisted of securities issued by banks. Assets issued by euro area MFIs represent 67.7% of the total euro area holdings of core domestic banks and these translate to 5.4% of their total assets.

Chart 3.12
EURO AREA HOLDINGS
(EUR millions; per cent)



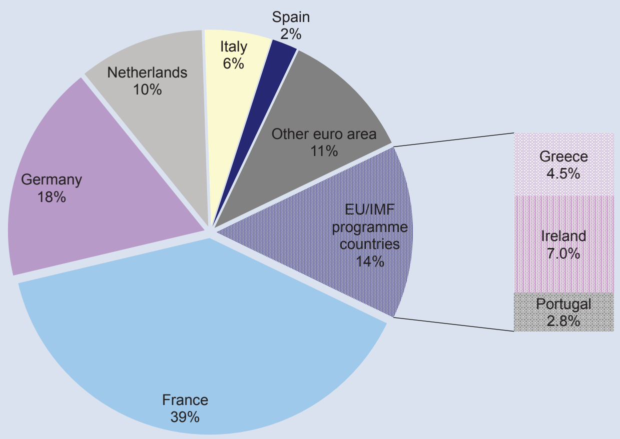
Note: Data excludes Maltese assets and holdings with the Central Bank of Malta. Data on loans to MFIs includes also deposits. 'Other' includes private companies excluding MFIs.

Source: Central Bank of Malta.

Euro area sovereign bond holdings accounted for only 18.4% of Tier 1 capital and 0.9% of total assets. In absolute terms the outstanding balance sheet value of such bonds remained stable. Falling market values were offset by net additions to the banks' aggregate holdings. The overall sovereign debt issued by the three EU-IMF Programme countries represented around 14% of the total euro area sovereign bond portfolio held by core domestic banks (see Chart 3.13). When compared with their Tier 1 capital, such holdings declined to 2.6% from 3.3%. In the specific case of Greece, as at end-2011 the value of securities held in the banks' balance sheet amounted to less than 1% of their Tier 1 capital. Developments concerning the Greek sovereign bond restructuring, therefore, did not at any point threaten the solvency of any core domestic bank.

In general, the risks associated with the euro area sovereign debt remained contained since, in terms of credit risk (as defined by the credit default swap [CDS] spreads of each respective country), around two-thirds of the euro area sovereign debt held by core domestic banks had a spread of below 200 basis points. Hence the majority of holdings were not directed at those countries which were perceived as most vulnerable by financial markets. Indeed, banks' foreign euro area sovereign bonds were dominated by France, which had a share of 39%. Furthermore, the second bail-out fund provided to Greece, together with the agreement to boost the funds available to the European Financial Stability Fund and the new European Stability Mechanism should also contribute to mitigate contagion risks across the euro area.

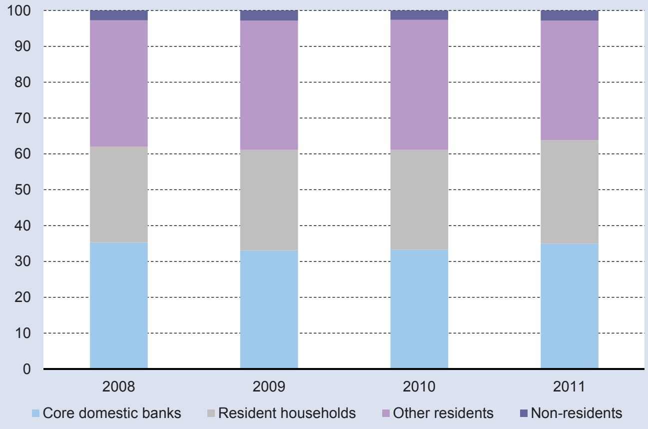
Chart 3.13
EURO AREA SOVEREIGN BOND HOLDINGS



Source: Central Bank of Malta.

3.2.2 Malta Government Stocks

Chart 3.14
MGS BY OWNERSHIP
(per cent)



Source: MSE.

Core domestic banks maintained a high level of investment in domestic sovereign bonds which, as at end-2011, accounted for around half of their investment portfolio, equivalent to 12.6% of their total balance sheet. Around 35% of the outstanding Malta Government Stocks (MGS) were held by the core domestic banks (see Chart 3.14). While the skewness in favour of domestic sovereign bonds remained observable across the euro area countries, the core domestic banks' share of holdings in local bonds is significantly above the euro area average. The high ownership by banks in part reflected the attractive risk-return yields associated with such bonds.

Although there was a downgrade since the beginning of 2011, the yields on domestic sovereign bonds remained stable given the low risk mainly attributed to the country's economic stability.[8] Unchanged yields were also supported by the fact that 97% of MGS were held by residents. Debt servicing costs were barely impacted by the downgrade as confidence in the sustainability of public finances was not undermined. The lack of issuance of private sector bonds, subdued credit demand, and the heightened uncertainty concerning other countries' sovereign bonds, maintained the demand for MGS stable.

The roll-over risk facing Government thus remained low and was further supported by the first bond auction of 2012 through which Government tapped sufficient funds to cover a significant share of the financing needs of maturing bonds for the year. This followed the successful Switch Auction Programme, which started off during late 2011, and through which the Treasury had already replaced an equivalent of around 4% of outstanding bonds with longer dated bonds.[9] This Programme is expected to be repeated again during 2012.

3.3 Funding

Funding and liquidity remained at satisfactory levels as core domestic banks continued to finance the bulk of their assets through customer deposits, although the latter increased at a slower pace compared with previous years. Given their strong fundamentals, core domestic banks made limited use of wholesale funding. Some progress was also made towards lengthening deposit maturities, ahead of the more demanding liquidity requirements that will come into effect in 2015.

3.3.1 Deposits

The banks' customer deposit base remained strong and was equivalent to 80.4% of total assets. The non-resident component of these deposits amounted to 12.6%. As a proportion of total liabilities, resident house-

[8] Since the beginning of 2011 Moody's downgraded Malta's sovereign debt by two notches, from A1 to A3, whereas Standard and Poor's downgraded Malta' sovereign debt by one notch from A to A-. Fitch kept its credit rating stable at A+.

[9] The Switch Auction Programme consisted of a voluntary exchange of the 5.7% MGS 2012 (III) into the new 4.3% MGS 2016 (IV), with EUR159.9 million of such bonds being exchanged.

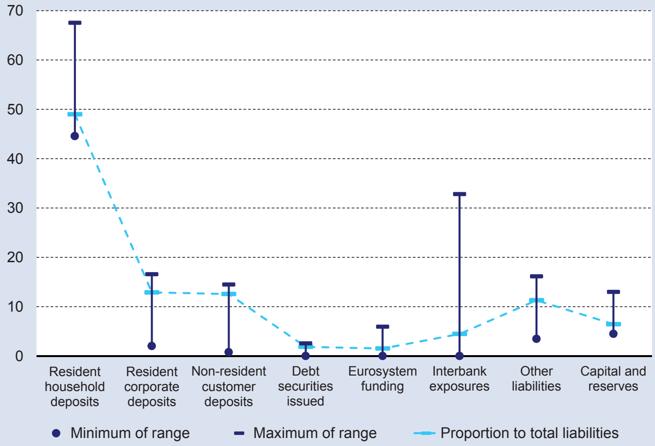
hold deposits were equivalent to 50% while corporate deposits represented 13% (see Chart 3.15).

Growth in total customer deposits was down on the previous year's growth rate, from around 10.1% to 1.4%. This was mainly due to development in non-resident deposits, which contracted by 12.8% following two years of strong growth (see Chart 3.16). The scaling back in non-resident deposits appeared to be mainly attributable to the volatile nature of certain corporate deposits. Growth in resident customer deposits also decelerated, to around 5%, when compared with the 7% average growth in previous years.

From a currency structure perspective, the deceleration in customer deposit growth was driven by a drop in non-euro deposits mainly reflecting movements in non-resident deposits as mentioned above. The slower resident customer deposit growth occurred despite a further rise of 12.4% in resident corporate deposits, which was nevertheless lower than the 22% growth registered in 2010.[10] However the substantially high growth rates of corporate deposits appear to be temporary and may reflect the fact that investment decisions are being postponed until the business climate becomes more positive.

Slower economic growth and the high volume of MGS issues in the capital market are likely to have contributed to the decelerating pace of deposit inflows. Indeed resident customer deposits may continue to expand at a modest pace in the near term, particularly if economic growth remains below trend. Despite increased competition from non-core domestic banks, funding risk concerns among core domestic banks remain low (refer to Box 2 for further details on activities of the

Chart 3.15
BANKS' LIABILITY COMPONENTS
(per cent)

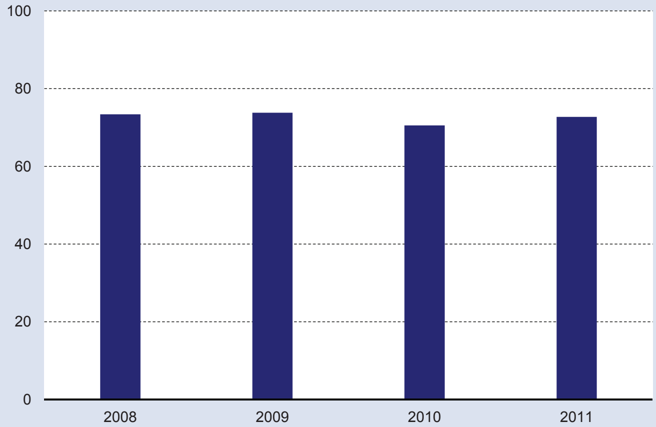


Source: Central Bank of Malta.

Chart 3.16
GROWTH IN CUSTOMER DEPOSITS
(per cent)

Source: Central Bank of Malta.

Chart 3.17
CUSTOMER LOANS-TO-DEPOSITS RATIO
(per cent)



Source: Central Bank of Malta.

[10] Even when considering the total banking system, resident deposits expanded at a slower pace compared with 2010.

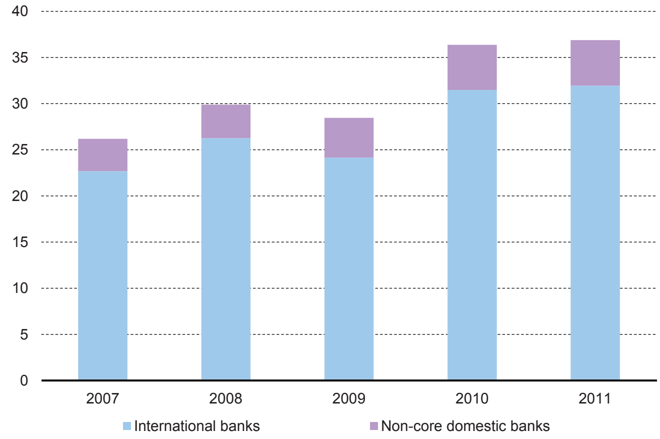
rest of the banking system in Malta). Furthermore, the customer loan-to-deposit ratio remains consistently low across all banks, standing at 72.7% on aggregate, despite rising by around 2 percentage points on a year earlier (see Chart 3.17). By international standards, the customer loan-to-deposit ratio stands low for core domestic banks (refer to Chapter 4, Section 4.1, Chart 4.6). Resident household deposits, which are regarded as more stable, account for around 84% of total customer loans.

BOX 2: NON-CORE DOMESTIC BANKS AND INTERNATIONAL BANKS

The various sections of the *Financial Stability Report* focus on developments in core domestic banks and on their associated risks, since these are the main financial intermediaries providing banking services to residents in Malta and which have a significant link to the domestic economy.[1] This Box supplements the main analysis contained in the *Report* by reviewing and assessing the performance of all other banks operating from Malta. Potential risks that could emerge from these other institutions are also highlighted in the analysis. A total of 21 other institutions operate from Malta. These comprise eight classified as non-core domestic banks and 13 as international banks (see Table 1). The majority of these banks are subsidiaries of EU banks offering a range of services that include trade finance, investment banking and group funding operations. Their size also varies considerably, as two of the banks classified as international vastly exceed the size of the other banks.

Total assets managed by the non-core domestic and international banks remained almost unchanged during 2011 at just under EUR37 billion (see Chart 1). International banks accounted for slightly under 90% of these assets. Reflecting the limited operations carried out with residents, the balance sheets of non-core domestic banks showed that only 9% of assets and 12% of liabilities

Chart 1
TOTAL ASSETS
(EUR billions)



Source: Central Bank of Malta.

Table 1
LOCATION OF HEAD OFFICE

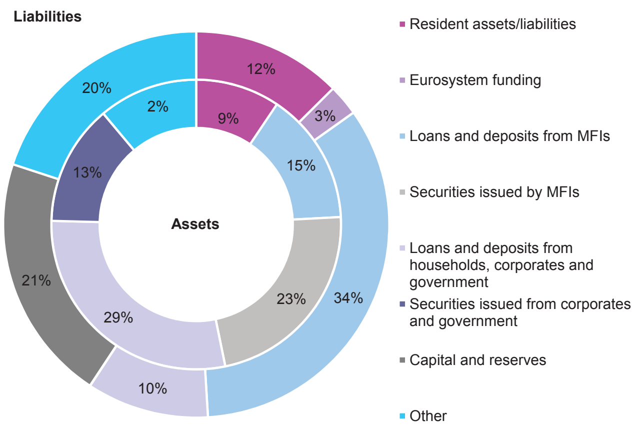
		Non-Core Domestic Banks	International Banks	Total
Malta		4	3	**7**
EU	Branch	1	0	**1**
	Subsidiary	3	6	**9**
Non-EU	Branch	0	2	**2**
	Subsidiary	0	2	**2**
Total		**8**	**13**	**21**

[1] The methodology explaining the classification of banks, insurance companies and investment funds is found in a special article in this *Report*. The Appendix includes the financial soundness indicators for different banking groups.

were, respectively, claims on, or due to residents (see Chart 2). In the case of international banks, these ratios were considerably lower at 2% in respect of assets and 0.3% in respect of liabilities (see Chart 3).

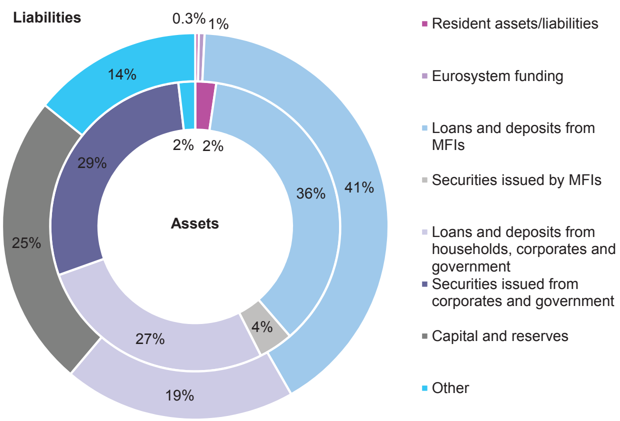
Loans represented some two-fifths of the balance sheet for both categories, while securities represented one-third. Lending was predominantly channelled to the non-resident corporate sector and, to a lesser extent, to other banks overseas. Credit extended to households remained minimal. During the year, both categories of banks scaled back their loan portfolio. In the case of non-core domestic banks this contracted by 11.8%, while for international banks it declined by 13.3%. The negative growth reflected movements in interbank loans, which fell by 45.3% and 17.1%, respectively, for non-core and international banks. Such declines mainly reflected lower intragroup transactions. Customer lending (both to households and corporates) decreased by a lower extent: 3.5% in the case of non-core banks and 11.2% for international banks. Customer loans were mainly directed to non-EU residents, and were extended predominantly by the international banks (see Chart 4). Credit to residents by all other banks remained minimal, with non-core domestic banks lending at just under EUR248 million, while that granted by international banks was a modest EUR8 million. In

Chart 2
BALANCE SHEET STRUCTURE OF NON-CORE DOMESTIC BANKS



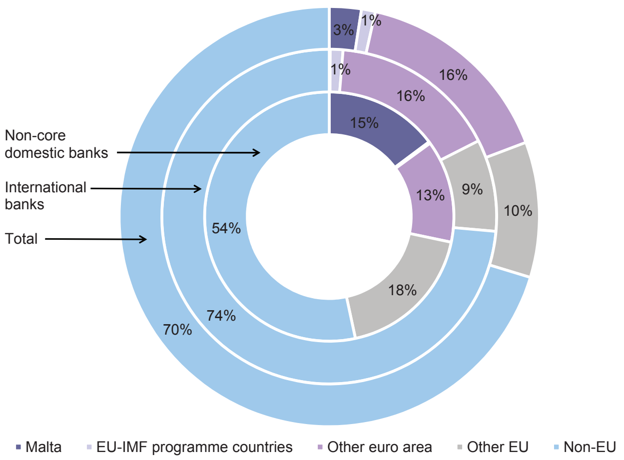
Source: Central Bank of Malta.

Chart 3
BALANCE SHEET STRUCTURE OF INTERNATIONAL BANKS



Source: Central Bank of Malta.

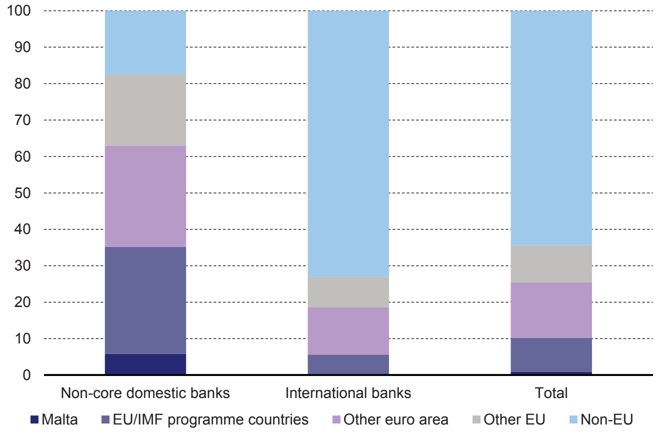
Chart 4
CUSTOMER LOANS BY RESIDENCY (2011)



Source: Central Bank of Malta

total, resident lending by non-core domestic banks accounted for only 2.9% of total resident loans in Malta and 0.1% in the case of international banks. The bulk of lending to residents was allocated to the construction and real estate sector. Both categories of banks reported low NPL ratios: non-core domestic banks at 4.5% and international banks at a marginal 0.5%.

Chart 5
INVESTMENT SECURITIES BY RESIDENCY (2011)
(per cent)



Source: Central Bank of Malta.

With regard to the geographic diversification of investment portfolios, international banks held over 70% of their investment holdings in non-EU countries, mainly Turkey, in view of the presence of two large branches of Turkish banks within this category (see Chart 5). For both bank categories, holdings of securities issued by the three EU-IMF Programme countries accounted for 9.3% of their combined total securities. However, such holdings were more pronounced in the case of non-core domestic banks, accounting for almost 30% of their investment assets. The majority of such holdings consisted of privately issued bonds. Meanwhile, domestic securities accounted for only 6% of total securities held by non-core domestic banks, and for a negligible percentage in the case of international banks. Such securities were practically all channelled into MGS, which nevertheless, only accounted for 2.4% of outstanding MGS, limiting the overall market impact in case of disposal.

Both bank categories primarily obtained their funding from wholesale markets (including intragroup funds), which financed around 29% and 44% of total assets of non-core domestic banks and international banks, respectively. No signs of parent bank funding pressures were observed among these banks. Additional financing obtained from the Eurosystem remained low at 2.5% of total assets in the case of non-core domestic banks, and just 0.5% of assets of international banks. Resident interbank liabilities by non-core domestic banks and international banks remained low, below 0.3% of their combined total liabilities, limiting the extent of interconnectedness to the financial system.

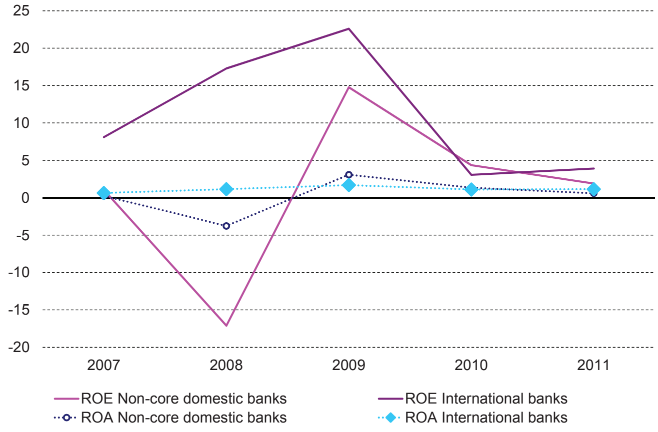
Customer deposits, which fund almost one-fifth of the banks' balance sheet, were predominantly non-resident and in currencies other than the euro. Despite the relatively strong expansion during 2011, deposits held with non-core domestic banks represented only 4.2% of total resident customer deposits in Malta. In the case of international banks, the proportion was a marginal 0.1%.

Only three of the non-core domestic banks have issued debt securities on the MSE. The total value of these securities increased slightly to around EUR90 million during 2011, equivalent to about 10% of the total amount of listed private sector bonds quoted on the Exchange. These securities are almost entirely held by residents, primarily by households. Only one non-core domestic bank has shares quoted on the MSE, equivalent to about 3.5% of total listed private sector equities. The bulk of these shares is held by non-residents.

During 2011 non-core domestic banks reported a decline in their profit before tax, while international banks reported an increase. Thus, in the case of non-core domestic banks, the return on equity

(ROE) dropped to 1.9% from 4.4% and the return on assets (ROA) fell to 0.6% from 1.3% (see Chart 6).[2] Though the fall in profits was predominantly driven by trading losses, higher net impairment charges also contributed to this drop. On the other hand, the ROE and ROA of international banks remained relatively stable at 3.9% and 1.1%, respectively, since the impact of lower trading profits was offset by higher net interest income and lower net impairment charges.

Chart 6
PROFITABILITY
(per cent)

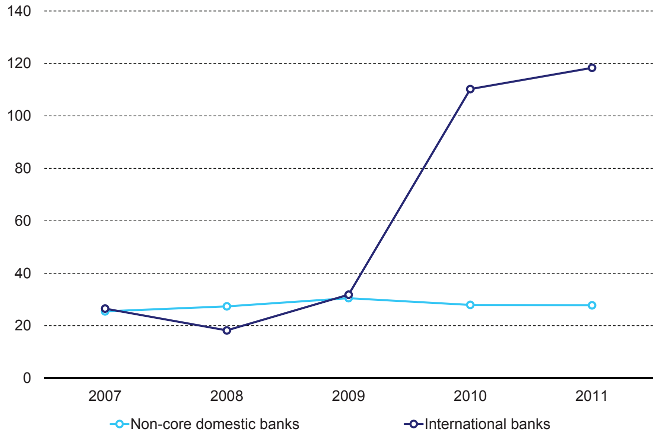


Source: Central Bank of Malta.

Both non-core domestic banks and international banks maintained high solvency ratios, with their Tier 1 capital ratios at 27.7% and 118.3%, respectively (see Chart 7). The high solvency positions reflected a number of strengths in the balance sheet structure of these banks, including a reliance on capital as a main source of funding and a high proportion of investments in assets with low risk weights. The leverage ratio (capital and reserves to assets) remained healthy and stood at 23.9% in the case of non-core domestic banks and at 64.1% for international banks. Liquidity also remained at a high level as the proportion of liquid assets to short-term liabilities stood well above the 30% regulatory requirement. In fact, the ratio stood at 90.7% for non-core domestic banks and at 112.4% for international banks.

The impact of these two categories of banks on the Maltese economy and on the financial system remains fairly limited, and the risk they pose to financial stability is assessed to be low. The majority of these banks primarily perform intergroup activities so that their interconnectedness to the rest of the financial sector is minimal. This significantly mitigates the possibility of adverse spillover effects, particularly in view of the fact that they offer only limited banking services to residents. Borrowing from, and lending to, residents are minimal.

Chart 7
TIER 1 CAPITAL RATIO
(per cent)



Source: Central Bank of Malta.

[2] In the case of ROE, the calculations exclude branches.

This notwithstanding, the banks in these categories could exert pressure on Malta's Depositor Compensation Scheme if one of them faces solvency difficulties. The extent of this risk varies, since the funds available to the Scheme match the covered deposits of a number of small and medium-sized institutions. Moreover, the likelihood of a need for ex-post additional contributions is also considered low since both non-core domestic banks and international banks have high capital and liquidity ratios, well above minimum requirements.

During the year banks launched a series of special fixed term deposit products with longer maturities, some of which were offered at variable rates (linked to developments in pre-set international indices). These products contributed to a rise in the share of longer-term deposits in total deposits, to 9.4% in 2011 from 7.3% in 2010. This also contributed to a lengthening of the banks' overall liability maturity structure as reflected in the proportion of long-term liabilities, which increased to 10.2% from 7.8% of total liabilities.

3.3.2 Eurosystem and wholesale funding

In line with previous years, core domestic banks made only limited use of Eurosystem funding. The low reliance on Eurosystem funding is also reflected by the fact that only around 14% of their eligible securities were pledged with the Central Bank of Malta as collateral for access to Eurosystem borrowing facilities. Moreover, the quality of the collateral placed with the Central Bank of Malta by core domestic banks remained very high, shielding them from sudden increases in margin requirements.

In 2011 Eurosystem funding amounted to 1.5% of total liabilities (including capital), up from 0.9% a year earlier. However, this rise largely reflected the participation by some banks in a new three-year Long Term Refinancing Operation (LTRO) which was conducted by the European Central Bank (ECB) in December. Whereas this new tool was introduced by the ECB primarily to alleviate liquidity pressures facing banks, the local banks' interest in the facility was mainly because of favourable conditions tied to its use. For the same reason, the provision of a further three-year LTRO in February 2012 again proved attractive for banks whose reliance on Eurosystem financing thus edged up to 1.9% of total liabilities (including capital) as at March 2012. On the other hand, none of the five core domestic banks needed to resort to the US dollar funding options which were made available by the ECB. Indeed US dollar funding constituted only 7.3% of core banks' total liabilities (including capital), with the bulk of this hedged against US dollar denominated assets.

Core domestic banks made little use of wholesale funding and, hence, such facilities with maturities of less than one year amounted to only around 6% of total liabilities. These were entirely channelled into Treasury activities, particularly for the purchases of securities. The interbank component, predominantly intragroup transactions, financed only 4.5% of total assets, though this ratio varies widely in the case of particular banks. Funding through the use of debt securities also remained low and was equivalent to less than 2% of total assets. Once again none of the core domestic banks sought funding through the issue of new shares.

3.4 The non-bank financial sector

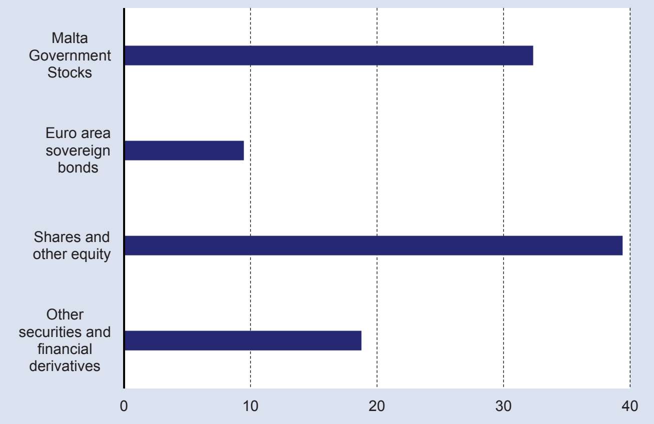
The domestic non-bank financial sector remained small but closely interconnected with the rest of the financial system. Performances across insurance and investment fund sectors were to a significant extent influenced by tensions in financial markets overseas. This was reflected in lower profits by the insurance sector and by a fall in the net asset value of the investment funds sector. This notwithstanding, the insurance sector remained resilient, while negative developments in the investment funds sector did not have a severe impact on household wealth. Longer-term risks, related to the relatively low level of reinsurance by domestic institutions and the limited diversification of asset holdings, however, continued to prevail.

3.4.1 Domestic insurance companies

Risks for the domestic insurance sector (comprising three life and five non-life insurance companies) continued to be driven by the close interconnectedness of domestic insurance companies with core domestic banks. Indeed, these banks held significant shareholdings in three of the eight companies. Of these, one company accounted for around half the sector's total assets and gross premia written. This high level of concentration continued to persist despite cross-border competition. In fact, the gross premia written by insurers with a head office outside Malta did not exceed 1% of the market. In terms of assets, the domestic insurance sector remained small, equivalent to only one-seventh the size of assets of core domestic banks.

The investment profile of the insurance sector remained prudent although the level of concentration remained rather high. Furthermore, an asset liability mismatch was clearly evident in light of the longer-term nature of the sector's liabilities. Asset allocations remained broadly unchanged compared with 2010, with the investment portfolio accounting for 71% of the balance sheet value. In turn, domestic sovereign bonds accounted for almost one-third of the total investment portfolio (see Chart 3.18). Meanwhile, the proportion of shares and other equity (the majority of which were issued by foreign entities) amounted to 39.4%. The sector's holding of euro area sovereign debt, which was limited to 9.5% of the total investment portfolio, did not include any securities from EU-IMF Programme countries. Around 12% of total assets represented securities issued by, and deposits held with, the banking sector in Malta.

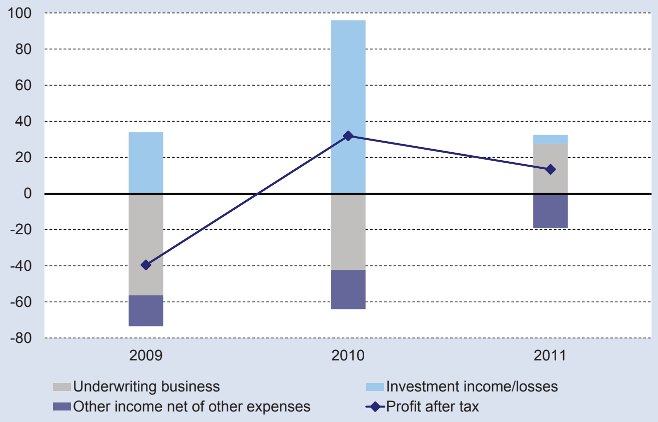
Chart 3.18
INVESTMENT ASSETS OF THE INSURANCE SECTOR
(per cent)



Source: Central Bank of Malta.

The challenging financial market conditions contributed negatively to the sector's net earnings on their security holdings. Indeed, investment income fell sharply on a year earlier, mainly owing to falling foreign security prices and the low interest rate environment (see Chart 3.19). On the other hand, the performance of the underwriting business contributed positively to profits, driven by the larger increase in total net premia (76.9%) compared

Chart 3.19
PROFIT COMPONENTS OF THE INSURANCE SECTOR
(EUR millions)

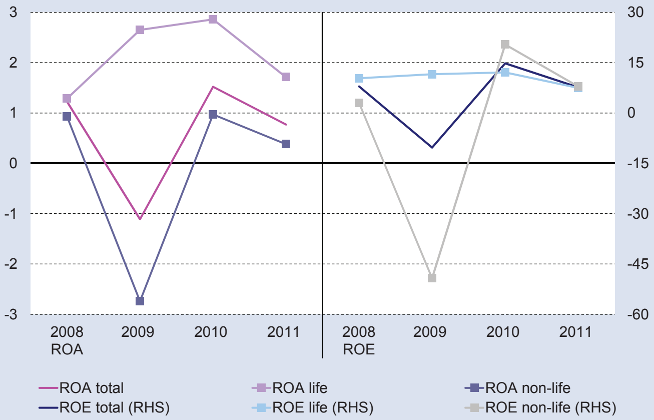


Source: Central Bank of Malta.

with net claims (14.9%).[11] Costs and incomes not directly related to underwriting business activities remained broadly stable compared with a year earlier.

On balance, as a result of the sharp drop in investment income, the domestic insurance sector's pre-tax profit was substantially lower compared with 2010. The ROE and ROA fell to 7.6% and 0.8%, respectively, from 14.8% and 1.5% a year earlier (see Chart 3.20).

Chart 3.20
PROFITABILITY OF THE INSURANCE SECTOR
(per cent)

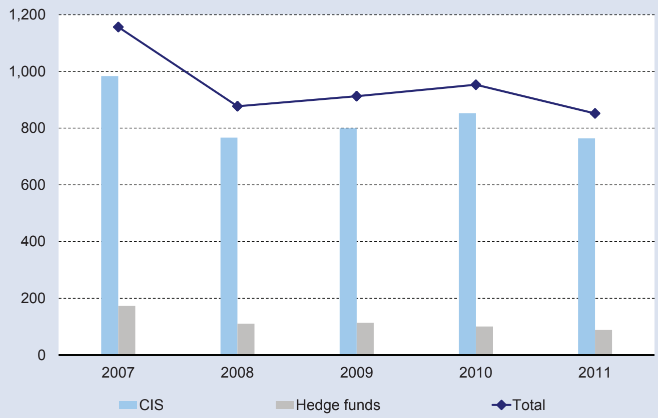


Source: Central Bank of Malta.

These ratios were broadly in line with the average for the euro area insurance sector in 2010 (7.4% and 0.7%).[12] Despite the weaker 2011 profit turnout, the capital position of the insurance sector remained broadly stable, supported by prudent distribution policies. At the end of 2011, the ratio of capital to total assets stood at 15.3%, comparable with the median of large insurance companies in the euro area.[13] Naturally, solvency levels remained higher among the non-life insurers whose business is generally associated with higher risks. It rose to 40.9% from 37.5% in 2010, while that for life insurers remained at a stable level of 11.5%. Technical reserves, which are set aside by insurance companies to cover future claims, increased by 4.4% on a year earlier.

The Risk Retention Ratio was estimated at 71% for the non-life segment and 96% for the life segment.[14] The insurance sector views the risk of huge claims resulting from catastrophic events as remaining low and mitigated through the application of clearly stated exclusion clauses. These exclusions however transfer the risk to policy holders and may thus have a negative implication for financial stability only through the downward effect on net wealth.[15]

Chart 3.21
NET ASSET VALUE OF THE INVESTMENT FUNDS SECTOR
(EUR millions)



Source: Central Bank of Malta.

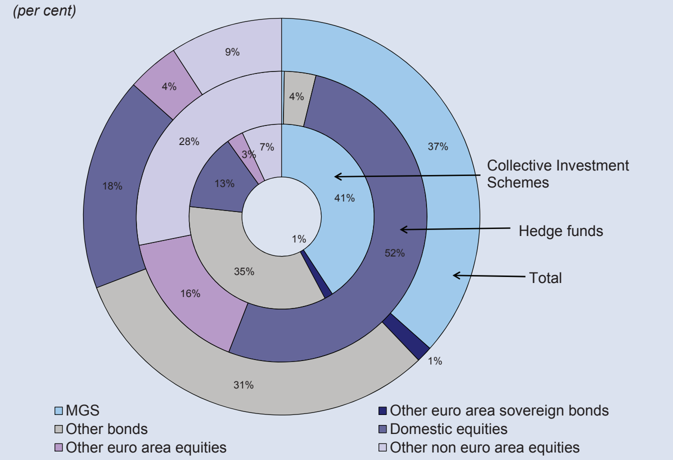
3.4.2 Domestic investment funds

Investment funds in Malta continued to be dominated by the domestic core banks which managed over 90% of these funds. Collective investment schemes (CIS) made

[11] Total net premia are defined as premia written for the year net of reinsurance, added to unearned premia reserves brought forward from 2010 less unearned premia reserves carried forward to 2012. Total net claims are defined as claims paid during the year net of reinsurance added to reserves for outstanding claims carried forward to 2012 less reserves for outstanding claims brought forward from 2010.
[12] Source: EIOPA, *Financial Stability Report 2011* - Second half-year report.
[13] Source: ECB *Financial Stability Review December 2011*.
[14] 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 reinsurers.
[15] The UN'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*.

up the bulk of the sector with hedge funds accounting for just 10%. The net asset value of investment funds contracted by almost 11% during 2011 (see Chart 3.21) with collective investment schemes experiencing drops of 10.4%, while the hedge fund category reported a decline of 12.4%.[16]

Chart 3.22
ASSET ALLOCATION OF THE INVESTMENT FUNDS SECTOR
(per cent)



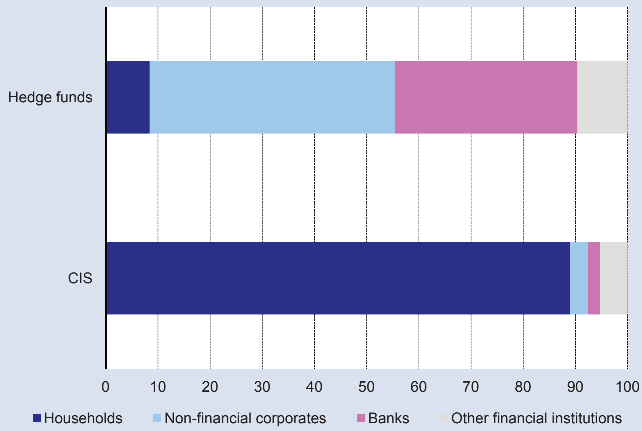
Source: Central Bank of Malta.

In both cases, the contraction in size was primarily attributable to lower asset valuations as a result of negative developments in international financial markets.[17] These were to some extent offset by the stronger performance of investments in domestic securities. Holdings of domestic sovereign bonds accounted for 37% of the sector's investment assets (see Chart 3.22).

In the case of collective investment schemes, these were equivalent to 41% while hedge funds were a marginal 0.3%. In turn, the share of holdings of sovereign euro area bonds was limited to only 1.5% in the case of CIS, whereas hedge funds had no such exposures. Equity holdings were dominated by the asset portfolio of hedge funds. These remained skewed towards shares quoted on the domestic stock exchange, with the latter accounting for some 52.1% of total investment assets. Of these, bank equity represented the bulk of such shares, highlighting the strong interconnectedness between investment funds and the banking system. On the other hand, direct exposures to commercial property by the investment funds sector remained negligible.

The domestic investment funds sector contracted further as a proportion of assets of core domestic banks, to an equivalent of 6%. However, as referred to above, the interlinkages of the sector with the banking system in Malta remained high. The systemic relevance of the domestic investment funds sector remained limited since households held only 5% of their gross household financial wealth in domestic investment funds, which in turn were mainly channelled into collective investment schemes (see Chart 3.23).

Chart 3.23
HOLDINGS IN INVESTMENT FUNDS
(per cent)



Source: Central Bank of Malta.

[16] 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, they are subject to limited regulation and oversight. As at end-2011, eight domestic collective investment schemes and five domestic hedge funds were in operation.

[17] One collective investment scheme surrendered its licence and stopped operations.

4. RESILIENCE OF THE FINANCIAL SYSTEM

The domestic financial system remained resilient and continued to improve despite the persistently challenging macro-financial environment. Sustained profitability was a key factor contributing to the banks' own funds and to the strengthening of their capital ratios. Thus, the capital adequacy of banks was maintained well above the regulatory limit with both the Capital Adequacy Ratio (CAR) and the Tier 1 capital ratio improving. The core domestic banks remained active in their intermediation operations.[1] The main sources of funding were once again deposits, which continued to register growth. Despite these positive developments, credit risk and concentration risk are still important challenges that should be addressed in the medium to long term, in order to further strengthen the resilience of the financial system. Credit quality remains sensitive to the performance of certain economic sectors, in particular real estate and construction. Banks are again encouraged to raise their loan loss provisions to counter credit risk, and to strengthen further their capital buffers. Furthermore, banks need to continue to lengthen the maturity profile of their liabilities to better match that of their assets.

4.1 Balance sheet developments

During 2011 the banks' balance sheet expanded by 5.2%, slightly lower than the growth rate of 6.5% registered a year earlier (see Chart 4.1). The growth rate of individual institutions ranged from -1% to 8%.

Over half the expansion in banks' total assets was attributable to an increase in their loan portfolio (see Chart 4.2). In aggregate, loans rose by 4.5%, mainly reflecting higher mortgage lending.

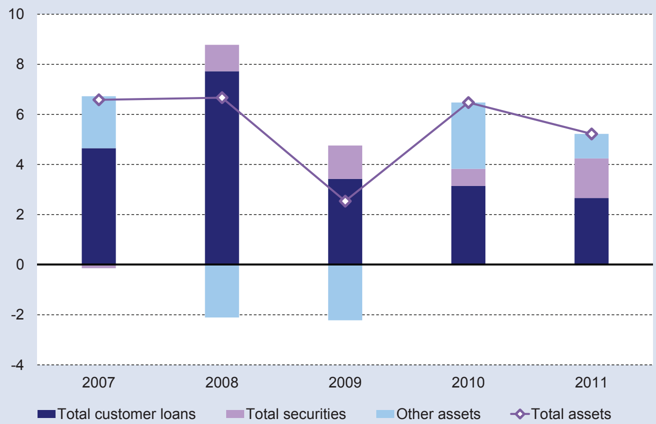
In line with the trend of recent years, lending to the household sector, predominantly mortgage lending, grew at a faster pace than corporate lending (see Chart 4.3). On the other hand, generally subdued credit demand and a lower risk appetite (particularly with respect to the construction industry) contributed to a deceleration in the growth rate of credit to the corporate sector, from 3.4% to 2.5%. In turn, placements with banks declined by 3.6%.

During 2011 the securities portfolio expanded by 5.4%. This portfolio contributed to around a third of

Chart 4.1
ASSET GROWTH RATES
(per cent)

Source: Central Bank of Malta.

Chart 4.2
CONTRIBUTION TO BALANCE SHEET GROWTH
(percentage points)



Source: Central Bank of Malta.

[1] All references to banks in this chapter refer to core domestic banks.

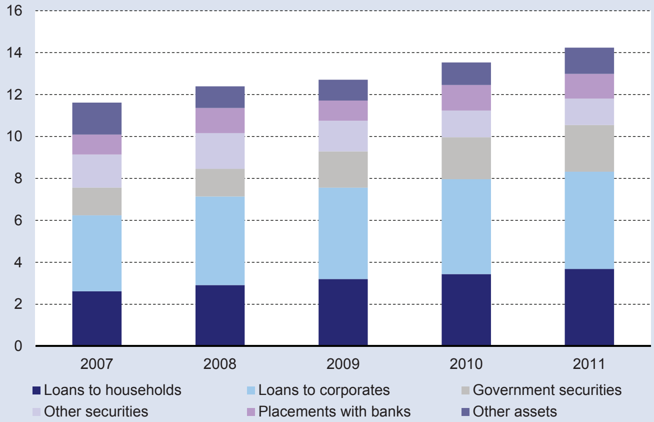
the increase in banks' assets. The percentage allocation of domestic and foreign securities was maintained practically unchanged, at 52.7% and 47.3%, respectively (see Chart 4.4).

Domestic security holdings consisted almost entirely of Malta Government Stocks (MGS), reflecting their attractiveness as safe investment assets and, thus, their eligibility as collateral where refinancing operations with the Eurosystem were concerned. Banks' holdings of foreign securities remained diversified across various countries (see Chart 4.5).

The proportion of securities, which are marked-to-market and hence vulnerable to valuation changes, stood at 70% of the total securities' portfolio.[2] On the other hand, the share of securities held for trading purposes remained very low at 1.2% of the total portfolio.

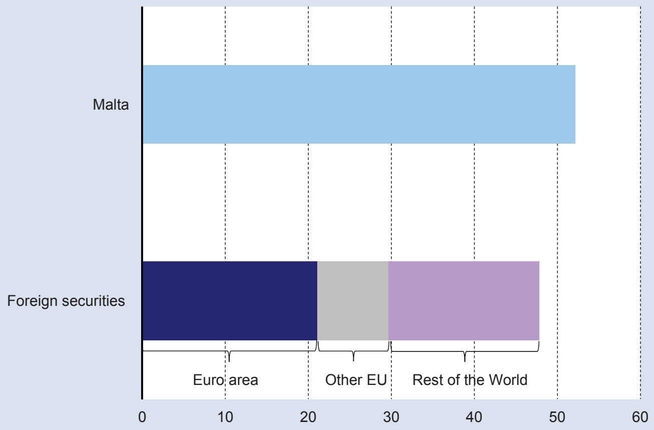
As in previous years, banks continued to rely on deposits to fund their credit and investment operations. At the end of 2011 these represented approximately four-fifths of total liabilities. Thus, compared with average ratios for banks in the euro area and the UK, the loan-to-deposit ratio of Maltese banks was lower due to the high level of funding through deposits (see Chart 4.6). While deposit inflows decelerated during 2011, banks made greater use of intragroup funding and Eurosystem funding. As a result, interbank funding, mainly intragroup, and Eurosystem funding contributed to 29% and 17.8%, respectively, of the balance sheet growth, after having contracted a year earlier. It was observed that banks' participation in the three-year Long-Term Refinancing Operation (LTRO) offered by

Chart 4.3
DISTRIBUTION OF BANK ASSETS
(EUR billions)



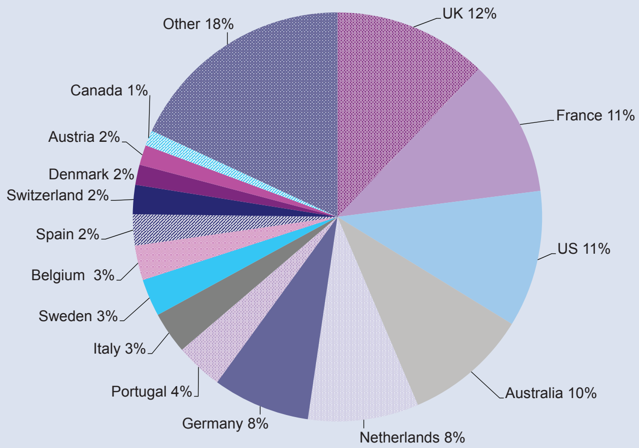
Source: Central Bank of Malta.

Chart 4.4
SECURITY HOLDINGS BY REGION
(per cent)



Source: Central Bank of Malta.

Chart 4.5
FOREIGN SECURITY HOLDINGS BY COUNTRY



Source: Central Bank of Malta.

[2] These assets are classified as "Available for Sale" or "designated at inception at fair value through profit and loss".

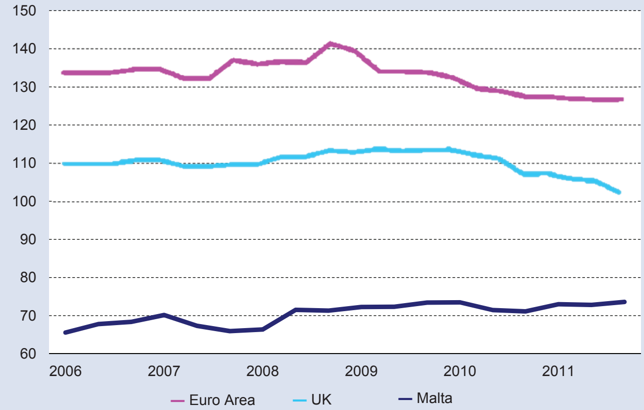
the Eurosystem towards the end of 2011 was mainly driven by the low cost of this financing facility, which thus offered opportunities for remunerative investment rather than for liquidity purposes.

4.2 Profitability

Banks' profitability remained healthy, although profits before tax dropped by 6.6% as a result of extraordinary expenditure items and a slight rise in non-interest expenses. The aggregate return on equity (ROE) declined by 2.8 percentage points to 19.6% (see chart 4.7). The return on total assets (ROA) dropped marginally to 1.3% from 1.4% in 2010. The ROE was affected to a large extent by the growth in shareholders' funds. On the basis of these ratios, the overall profit performance of Maltese banks remained significantly stronger than of small banks across the EU, whose ROE and ROA stood at 2.6% and 0.2%, respectively, for the first half of 2011.[3]

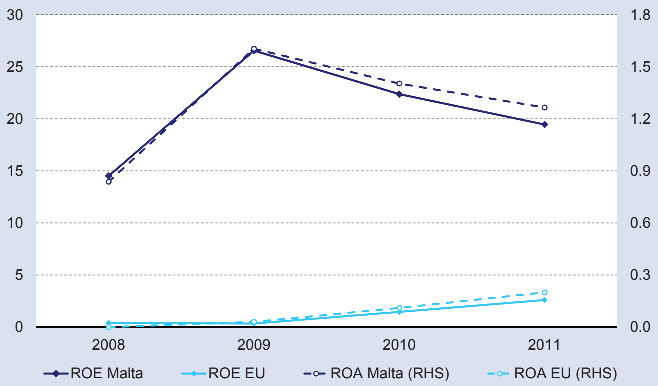
As in previous years, net interest income continued to be the main contributor to profits, representing 72.4% of gross income (see Table 4.1). It rose by 7.3% in 2011 compared with the previous year.

Chart 4.6
BANK LOAN-TO-DEPOSIT RATIO
(per cent)



Sources: IMF and Central Bank of Malta.

Chart 4.7
PROFITABILITY
(per cent)



Note: Data for small EU banks for 2011 relates to the first half of the year.

Sources: ECB Consolidated Banking Data and Central Bank of Malta.

Table 4.1
MAIN COMPONENTS OF THE PROFIT AND LOSS ACCOUNT
EUR millions

	2008	2009	2010	2011
Total net-interest income	**276,611**	**250,988**	**292,916**	**314,435**
Net interest income on intermediation	74,866	126,181	206,759	222,145
Other net-interest income	201,745	124,807	86,157	92,290
Non-interest income	**24,190**	**151,033**	**121,619**	**119,883**
Valuation gains/losses	(80,707)	30,057	1,575	(27,863)
Other non-interest income	104,897	120,976	120,044	147,746
Non-interest expense	**(199,661)**	**(203,024)**	**(227,438)**	**(259,550)**
Net profit before tax	**101,141**	**198,998**	**187,097**	**174,768**

[3] Source: European Central Bank (ECB) Consolidated Banking Data.

Interest income, directly attributable to lending activities, increased by around 4.6%, whereas interest paid on deposits remained broadly stable. In turn, the improved net interest earnings reflected the faster rate of growth in loans compared with deposits. The interest rate margin was also generally stable on a year earlier. Additional improvement in net interest income was attributable to a fall in the servicing of interest on issued securities against stable income from security holdings.

Following minor valuation gains in 2010, core domestic banks reported small valuation losses during 2011. Banks also reported lower fee income partly resulting from reduced trade operations. On the other hand non-interest income was boosted by higher dividend receipts and one-off income earnings relating to the sale of business lines. On aggregate, these developments led to a decline of 1.5% in non-interest income. Non-interest expenses increased by 14.2%, largely as a result of exceptional items, an out-of-court settlement and early retirement schemes. Meanwhile the growth in other non-interest expenses was contained to 2.8%.

The impact on profitability resulting from net impairment charges (which include write-offs, write-backs, provisions and recoveries) was similar to the previous year, despite deterioration in asset quality. Indeed, banks incurred higher collective provision charges and bad debt write-offs than a year earlier, but these were mostly offset by lower specific provision charges.[4]

Looking forward, the banks' performance should be favourably influenced by the Eurosystem monetary policy measures introduced in the earlier part of 2012, namely the reduction in the minimum reserve requirement to 1% and the second three-year LTRO in February. Indeed, banks can benefit from a more remunerative deployment of the liquidity released by the ECB. In addition, the long-term funding opportunities offered by the ECB through the three-year LTRO could also contribute to profitability as banks expand their Treasury operations. At the same time, other non-interest earning opportunities may become available as banks extend their activities in relatively new niche business, such as portfolio management and trusts.

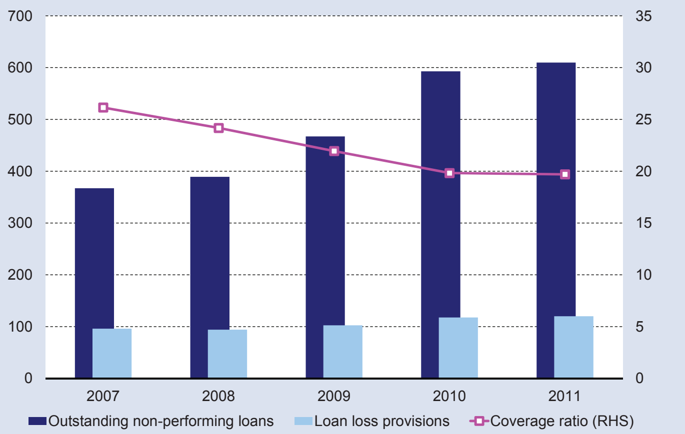
While the relatively low level of interest rates remain a challenge to banks' financial intermediation activities, it should encourage them to strengthen their resilience to liquidity positions - by addressing the maturity structure of their deposits through the offer of longer-term deposits to their customers.

While banks' return on equity continues to be adequate, increased competition and the obligation to meet stricter regulatory requirements in the coming years may exert downward pressures on their profits in the medium term. Consequently, prudent dividend policies, which reflect the economic and financial climate, are warranted, especially in the case of those banks whose capital ratios and/or profitability levels are lower than the average of core domestic banks.

4.3 Loan loss provisions and rescheduling

The banks raised their loan loss provisions by 2.2% during 2011, almost in line with the 2.8% growth rate in their non-performing loans (NPL) (see Chart 4.8). The overall expansion in total provisions entirely reflected higher collective provisions, which were raised by 16.1%. On the other hand, specific provisions contracted by 7.3% as a result of write-offs. Still, specific provisions allocated to loans extended to the real estate and construction

Chart 4.8
COVERAGE RATIO
(EUR millions; per cent)



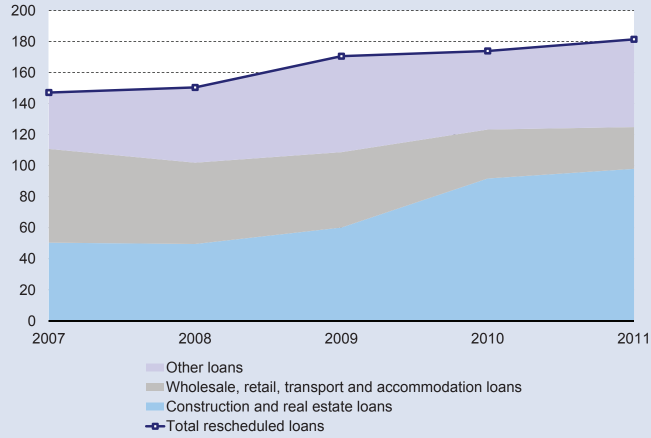
Source: Central Bank of Malta.

[4] Collective provisions, bad debts and specific provisions are considered in net terms, meaning that the impact of write-backs or recoveries is netted out.

sector were increased by around 7%. Indeed, core domestic banks continued to rely on collateral, in the form of property, as the prime buffer for credit risk mitigation.

The coverage ratio (total provisions to NPLs) remained stable at just under 20% when compared with 2010. Collateral backing NPLs was estimated at around 76%, and hence NPLs were almost fully covered by provisions and the value of collateral. The potential risk, however, was that, under distressed selling conditions, the collateral value would not be fully realisable. But the likelihood of this scenario materialising was partly mitigated by the fact that banks continued to apply significant haircuts to the initial valuation of the collateral, often in the region of 30%. Moreover, banks were guided by generally strict loan-to-value ratios (LtV) in their lending activities. These averaged 73% for residential loans and 63% for commercial property-backed loans.[5]

Chart 4.9
RESCHEDULED FACILITIES
(EUR millions)



Source: Central Bank of Malta.

Loan rescheduling procedures were further extended during 2011, with the value of such loans increasing by 4.3% over the year, corresponding to 2.2% of the total loan portfolio (see Chart 4.9). Recourse to rescheduling arrangements remained predominantly in the construction and real estate sectors, which accounted for approximately 80% of the overall rise during 2011. However, following a rise in 2010, the rescheduling of loans relating to the construction and real estate sector stabilised in 2011.

On aggregate, the construction and real estate sectors represented over 50% of the outstanding stock of rescheduled facilities. Such rescheduling stretches the time horizon of the loan, thereby contributing to the likelihood of repayment in an environment of slower growth. However, such rescheduling may also give rise to systemic risk if the new terms of the loan are not adhered to. In this respect, banks are encouraged to monitor closely such loans, and where necessary, increase provisioning to sustain banks' resilience.

4.4 Liquidity ratios and maturity mismatch

During 2011 banks continued to comfortably meet their statutory liquidity requirements. Indeed, the aggregate liquidity ratio (liquid assets to short-term liabilities) stood at 44% at the end of the year (see Chart 4.10). All banks exceeded the 30% regulatory threshold by at least 10 percentage points. Around two-thirds of liquid assets consisted of marketable debt securities. The cash ratio, which is a more rigorous measure of liquidity stood at around 14% of short-term liabilities, down by around 1 percentage point compared with 2010.

Chart 4.10
LIQUID ASSETS
(EUR billions; per cent)

Source: Central Bank of Malta.

[5] The LtV ratios are based on survey replies.

According to the provisions governing the liquidity coverage ratio under the new Capital Requirements Directive (CRD) IV framework, which is expected to come into force in 2015, banks will be expected to maintain enough liquid assets to meet the notional amount of cash outflows occurring over a 30-day period. In this regard, therefore, the high proportion of current and savings accounts (52.5% of customer deposits) on the balance sheet of core banks has implications as they will be constrained to augment their holding of liquid assets. Though such deposits provide low cost funding for banks, they entail an element of liquidity risk since they can be easily withdrawn.

4.5 Capital and leverage

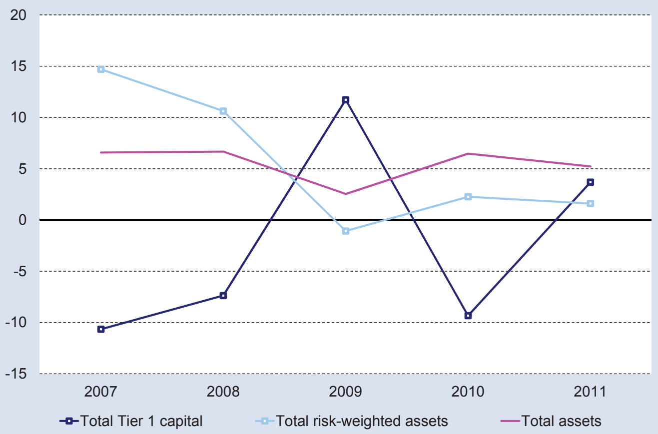
On aggregate, banks continued to increase their Tier 1 capital as a result of growth in retained earnings (see Chart 4.11).

With Tier 1 capital rising by around 5% on a year earlier and exceeding the growth in risk-weighted assets, the Tier 1 ratio increased by 0.3 percentage point to 9.5% (Chart 4.12). This was significantly higher than the 4% level required under current local regulations.

Tier 2 capital was also higher so that the Capital Adequacy Ratio (CAR) increased slightly more, by 0.6 percentage point, to 13.5% at the end of 2011, well above the 8% statutory requirement. New shares issued during the year took the form of bonus issues and these merely involved the transfer of funds from retained profits to equity, without any impact on the overall own funds position of the banks. This capitalisation of distributable reserves contributed positively to the quality of the capital base. The aggregate Tier 1 ratio, at 9.5%, was lower than the European Union (EU) average of 10.9%. However, significant heterogeneity existed across banks in Malta, with Tier 1 ratios ranging between 4.4% and 18.7%.

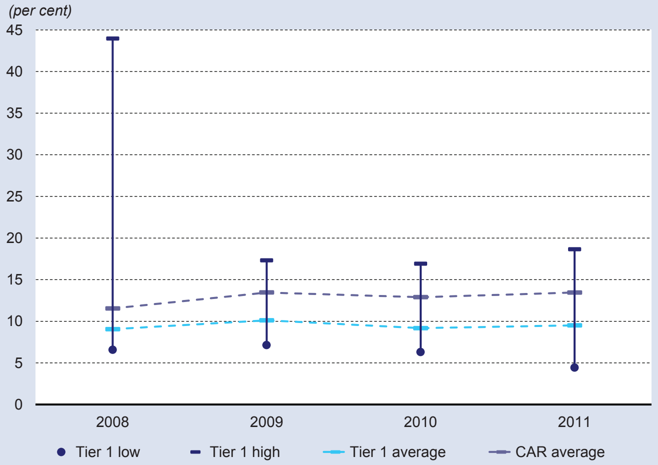
The increase in the Tier 1 ratio reflected a faster build-up of undistributed profits compared with the growth in risk-weighted assets. Indeed, banks' assets, which carry a higher risk-weight, rose at a slower pace than those which fall into the lower risk-weight categories, such as mortgage loans and government securities.[6] The ratio of risk-weighted assets to total assets thus contracted to 51.8% in 2011

Chart 4.11
GROWTH IN TIER 1 CAPITAL AND RISK-WEIGHTED ASSETS
(per cent)



Source: Central Bank of Malta.

Chart 4.12
SOLVENCY RATIOS
(per cent)

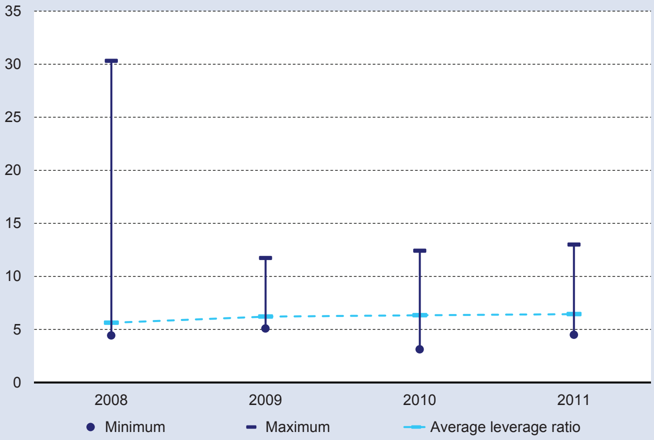


Source: Central Bank of Malta.

[6] All five 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.

from 53.7% in 2010. At the same time, the leverage ratio improved marginally by 0.1 percentage point to 6.4% (see Chart 4.13).[7,8] All banks registered a modest rise in this ratio and the bank with the lowest capital-to-assets ratio registered an improvement of 1.4 percentage points to 4.5%.

Chart 4.13
LEVERAGE RATIO
(per cent)



Source: Central Bank of Malta.

Here, again, it is relevant to mention that under the CRD IV framework banks will face a tighter capital adequacy regime. The framework relating to capital, which comes into effect in January 2013, allows for a gradual build-up of capital and will introduce new variable capital buffers, such as one related to systemic risk and another related to counter-cyclical effects. In the local context, while current dividend and retention policies are consistent with healthy solvency ratios, the policies may have to be revisited in future to ensure that banks meet the forthcoming minimum Tier 1 capital requirement and to sustain the current five-year average growth in risk-weighted assets.

4.6 Stress tests

Stress tests evaluate the extent to which banks may be able to withstand the materialisation of hypothetical extreme, yet plausible, shocks – more specifically, whether banks' existing solvency and liquidity buffers suffice to absorb the modelled shocks, contingent on the assumptions adopted. All stress tests considered in this *Report* are nevertheless univariate in nature, and since no endogenous reactions were regarded, results are to be considered as indicative. Stress tests are top-down and aimed at evaluating fragilities across the system, rather than at the individual bank level to which bottom-up stress tests are more applicable.[9] On the basis of the analysis carried out in this *Report*, the following four scenarios were deemed to be the most relevant: (i) asset quality deterioration; (ii) an economic downturn; (iii) a downward correction in house prices; and (iv) persistent deposit withdrawals.[10] These scenarios broadly capture the element of credit risk, sovereign risk and liquidity risk. There appears to be a low possibility that the first three scenarios may occur. The likelihood of a deposit run is considered to be remote. In general, the stress tests undertaken by the Central Bank of Malta broadly confirmed the banks' overall resilience but they also highlighted some vulnerabilities.

4.6.1 Scenario 1 – asset quality deterioration

Banks' resilience to asset quality deterioration was assessed by evaluating the impact on Tier 1 capital following the assumed materialisation of the probability of default (PD) and loss rates (LR) applicable to core domestic banks' loans and securities.[11] The benchmark PDs and LRs were projected over the horizon 2011 to 2012 for both a baseline as well as for an adverse macroeconomic scenario across a number of sectors (institutions, sovereigns, corporate and retail). Under the baseline scenario, the materialisation of the shock was estimated to shave off only around 1.5 percentage points from the aggregate banks' Tier 1 capital ratio to 8%, reflecting

[7] The leverage ratio is defined as capital and reserves to balance sheet assets.
[8] This computation does not, however, consider off-balance-sheet exposures. These are included in the calculation of the forthcoming leverage ratio requirement. The latter will be an important indicator under the future regulatory regime.
[9] Whereas top-down stress tests rely almost exclusively on statutory data, and in the main ensure equal treatment of all banks considered, bottom-up stress tests are more data intensive and can be tailored to the peculiarities of each bank.
[10] These scenarios are in line with those presented in previous issues of the *Financial Stability Report*. Results are however not directly comparable since the latest stress tests are based on a new sample of five banks, and in some cases the application of slightly different methodology.
[11] The estimated PDs included in this test were those applicable to the Bank of Valletta plc as provided by the European Banking Authority (EBA) in its 2011 EU-wide stress testing exercise. For further technical information refer to http://www.centralbankmalta.org/site/stresstest_2011.html and the links therein.

the generally high quality of banks' assets (see Chart 4.14).[12] Indeed, even under an adverse scenario, the Tier 1 ratio at 7.0% was well above the regulatory requirement of 4% despite an overall downside impact estimated at 2.5 percentage points.

4.6.2 Scenario 2 – an economic downturn

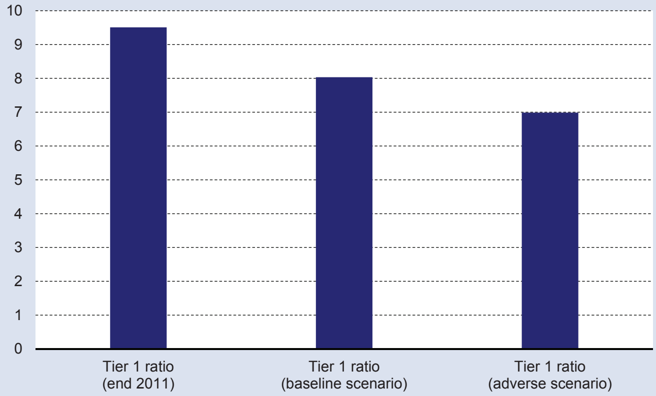
The economic downturn scenario in turn assumed a sharp contraction in key economic sectors, leading to a strong increase in the NPLs of up to 15%. The impact was assessed on households and specific corporate sectors, namely construction and real estate; wholesale and retail; and accommodation services. The rise in NPLs was assumed to require additional specific provisioning on a one-to-one basis, thereby leading to a decline in retained earnings and, consequently, in solvency. Risk-weights on a number of assets were also estimated to rise, mirroring the lower quality of such assets. In this framework, the aggregate downside impact on the Tier 1 ratio under the more adverse scenario was estimated to fall by 2.6 percentage points, lowering the banks' Tier 1 ratio from 9.5% to 6.9% (see Chart 4.15).

The strongest impact would be driven by the adverse shock to the household sector component, consistent with the strong share of mortgages in total bank lending (see Chart 4.16).

4.6.3 Scenario 3 – a downward correction in house prices

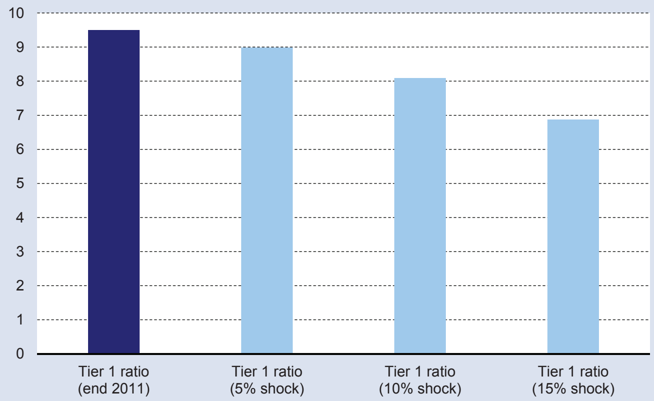
Under this scenario, a generalised drop in house prices was assumed to lower the collateral values by varying percentages over and

Chart 4.14
STRESS TEST RESULTS – IMPACT OF ASSET QUALITY DETERIORATION ON TIER 1 CAPITAL
(per cent)



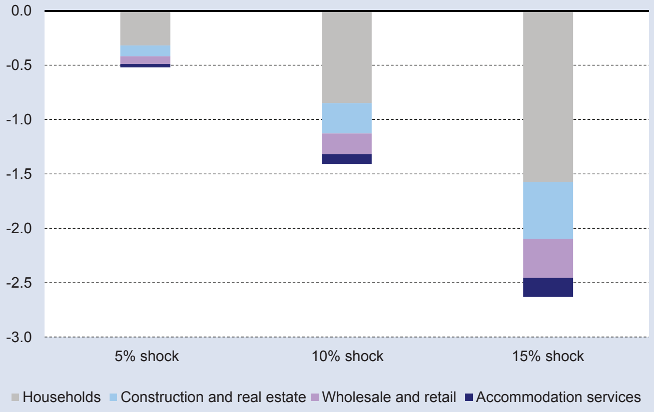
Source: Central Bank of Malta calculations.

Chart 4.15
STRESS TEST RESULTS – IMPACT OF AN ECONOMIC DOWNTURN ON TIER 1 CAPITAL
(per cent)



Source: Central Bank of Malta calculations.

Chart 4.16
STRESS TEST RESULTS – IMPACT OF AN ECONOMIC DOWNTURN BY SECTOR ON TIER 1 CAPITAL
(percentage points)

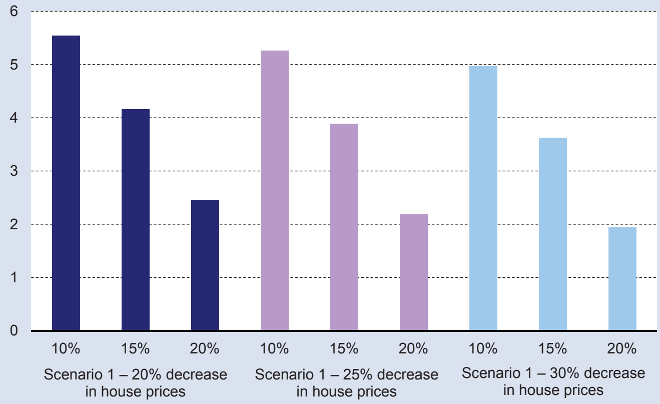


Source: Central Bank of Malta calculations.

[12] Risk-weighted assets were assumed to remain constant, in line with the EBA methodology.

above the conservative haircuts already adopted by banks on their collateral. This is considered to be a rather extreme scenario. Furthemore, this development was assumed to coincide with a significant increase in NPLs as a result of negative wealth effects. On aggregate, core domestic banks would be able to maintain a Tier 1 capital ratio above the 4% threshold, as long as the drop in collateral values and the increase in NPLs would be limited to 20% and 15%, respectively (see Chart 4.17).

Chart 4.17
STRESS TEST RESULTS – IMPACT OF HOUSE PRICE CORRECTION ON TIER 1 CAPITAL
(per cent; x axis = increase in NPL)

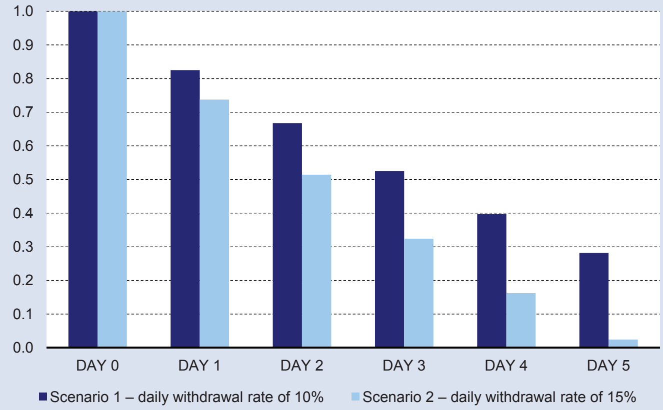


Source: Central Bank of Malta calculations.

4.6.4 Scenario 4 – persistent deposit withdrawals

Banks' liquidity resilience was tested by assuming a range of deposit withdrawals of between 10% and 15% for five consecutive days. The only counter-balancing activities permitted under this stress test were limited to the liquidation of assets which form part of the list of liquid assets as stipulated in the Banking Rules. The bulk of these assets were MGS. The disposal of assets not defined as liquid assets (such as loans) and recourse to contingency funding sources were not considered. Despite these very stressed conditions, on aggregate the banks would be able to withstand such extensive withdrawals. However, on a bank-by-bank basis, some banks would require to tap into other funding sources in order to absorb the assumed five-day persistent deposit withdrawals (see Chart 4.18).

Chart 4.18
STRESS TEST RESULTS – IMPACT OF PERSISTENT DEPOSIT WITHDRAWALS ON LIQUID ASSETS
(1 = liquidity index prior to shock)



Source: Central Bank of Malta calculations.

5. RISK OUTLOOK AND RECOMMENDATIONS

Domestic macroeconomic and financial conditions were generally benign during 2011 despite a relatively challenging global environment. Malta's financial system continued to exhibit a high degree of resilience during the year and financial stability conditions were broadly in line with those anticipated in the *Financial Stability Report 2010*. This *Report* establishes that most risks remained contained but some vulnerabilities persist.

5.1 The banking sector

Credit and concentration risks

During 2011 credit exposure, primarily to the construction and real estate sector, remained the main risk for core domestic banks at a comparable level to the previous year. The level of provisioning increased in line with the amount of non-performing loans (NPL). Concentration remained in the property market, which, despite being perceived as a secure form of investment and a form of wealth, is currently experiencing slow market conditions. In a more uncertain economic outlook, banks may face additional credit risks from the underperforming sectors. Although loans are predominantly covered by collateral in the form of immovable property, which is subject to significant haircuts, there remains a potential element of risk. If banks face pressures to dispose of their collateral to recover their lending, the realised collateral values could be insufficient to cover outstanding loan amounts, unless covered by provisions.

Despite the benign baseline projections for economic growth and house price developments, some downside risks remain, and hence banks are encouraged to increase their loan loss provisions, particularly in relation to lending to borrowers in more vulnerable sectors. Banks should also ensure that the valuation of collateral remains consistent with market prices, particularly since the housing market has in recent years experienced some downward correction. Banks are also encouraged to regularly assess customer creditworthiness so that any necessary risk mitigation measures can be taken at an early stage. Importantly, recourse to rescheduling of credit facilities should be restricted to just those cases in which the underlying quality of the loans has remained satisfactory after undertaking an in-depth analysis of the quality of the loan. Meanwhile, any losses associated with underperformance in clients' loan accounts should be reflected in the profit and loss account in a timely manner. On a longer-term perspective, more efforts should be made to ensure that concentration risk is mitigated through further diversification of portfolios.

Funding and solvency risks

Funding risks remained contained since, from a liquidity perspective, core domestic banks continued to rely on customer deposits to fund their loan portfolio as reflected by the low level of loan-to-deposit ratios. This notwithstanding, banks are urged to take further steps to extend the maturity of their customer deposits base, especially since the forthcoming regulatory liquidity requirements impose stricter measures on short-term deposits.

Solvency ratios continue to stand well above current regulatory requirements. However, the analysis contained in this *Report* observes a need for further strengthening of banks' capital base mainly through higher retained profits. This is necessary not only to mitigate the risks arising from the relatively high exposures to the property market, but also to ensure a gradual, yet timely, adherence to the more onerous regulatory capital requirements coming into force in the near future. The profitability conditions for 2012 are expected to remain supportive of such capital enhancement.

Other risks

The Government's relatively stable fiscal position and the strong tendency of residents to subscribe substantially to primary issues of domestic government bonds have shielded the Maltese economy and the financial sector from the direct turmoil of the euro area sovereign debt crisis. Furthermore, core domestic banks' exposure to sovereign debt securities issued by euro area countries most affected by the crisis remains low. Nevertheless, ongoing vigilance is necessary and close adherence to fiscal targets by the

Government is important. A more evenly spread maturity structure of government bonds would reduce roll-over risk and contribute positively to both macroeconomic balance and systemic stability in the financial sector.

In recent months steps were taken to strengthen the funding of the Depositor Compensation Scheme in the medium term. Such measures are in the right direction and should be extended further to better enhance the Scheme's resources, particularly as the size of eligible deposits and the number of banks operating in Malta continue to increase. This would also be consistent with the expected European Union (EU) legislation that will eventually introduce a common framework to further strengthen financial stability conditions in the EU.

In a broader international perspective, other areas of concern to financial stability, such as the contraction in US dollar funding and excessive foreign currency lending to unhedged borrowers, are not considered as posing risk to the Maltese financial system. Similarly, risks of deleveraging are considered to be minimal as the business focus of the core domestic banks continues to be locally oriented. This is supported by replies to a recent survey conducted by the Central Bank of Malta, which indicated that banks do not have plans for any major structural changes to their asset holdings during 2012. Meanwhile, the credit supply channel in the economy remains adequate despite the deceleration in credit growth observed in 2011. As stated above, the latter is mainly due to demand factors rather than to supply constraints.

Table 5.1 summarises the main high-level recommendations for financial institutions and authorities.

Table 5.1
MEASURES TO ADDRESS KEY RISKS IN THE FINANCIAL SYSTEM

Risks	Measures required	Time horizon
Credit risk	Improve coverage of NPLs through higher loan loss provisions	*Short-term*
Concentration risk		
Loan portfolio	Diversification of lending portfolio	*Long-term*
Collateral	Diversification of collateral base	*Long-term*
Regulatory changes (CRD IV)	Lengthen the maturity structure of deposit liabilities	*Short-term*
	Enhance capital buffers through higher profit retention	*Medium-term*
Contagion	Ensure higher funding for the Depositor Compensation Scheme	*Long-term*
	Reduce the risk retention of the long-term business insurance providers	*Long-term*

5.2 The insurance and investment fund sectors

In the insurance and investment fund sectors, systemic risks appear to be contained. However, insurance companies in Malta are encouraged to reduce risk in their balance sheets through higher levels of reinsurance.

SPECIAL FEATURE: METHODOLOGY TO CATEGORISE INSTITUTIONS FOR FINANCIAL STABILITY PURPOSES

The Maltese financial system is dominated by banking institutions which undertake a broad range of intermediation activities. A growing number of insurance companies and investment funds also operate within this system. Some of the financial institutions established in Malta have minimal or no link at all with the domestic economy as they transact almost exclusively with non-residents. To better monitor developments associated with systemic risk, the Central Bank of Malta has traditionally categorised institutions as domestic or foreign-oriented, depending on the extent of links with residents. As from this issue of the *Financial Stability Report*, a new methodology of classification is being introduced. The methodology is derived from recent literature that analyses different ways of categorising institutions according to the risk they pose to the financial system.

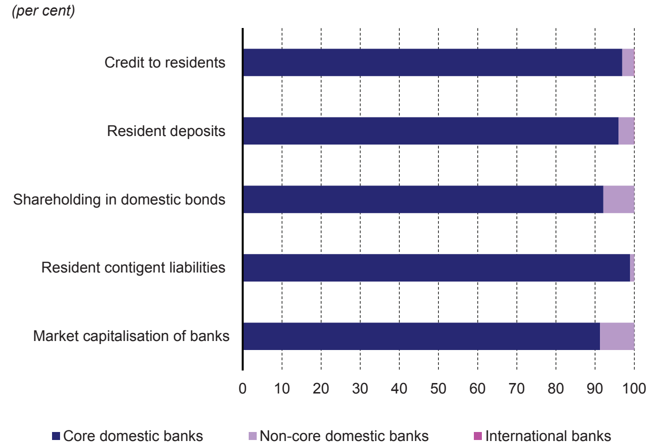
The banking sector

To identify the systemic relevance of banks operating from Malta, five broad criteria reflecting size, substitutability and connectivity were considered. Weights were then assigned to each criterion as shown below:[1,2]

(i) credit to residents [30%]: credit to residents by bank *i* to total resident loans;
(ii) resident deposits [30%]: resident deposits of bank *i* to total resident deposits;
(iii) holdings of domestic bonds [13.3%]: domestic bonds held by bank *i* to total outstanding domestic bonds;
(iv) resident contingent liabilities [13.3%]: resident contingent liabilities of bank *i* to total resident contingent liabilities of the banking sector;
(v) market capitalisation [13.3%]: market values of equities or bonds of bank *i* to total market capitalisation of banks in Malta.

The weighted standardised values of each criterion for every bank were then added.[3] On the basis of this methodology, three separate categories were identified: a group of five banks which scored highest; a group of 13 banks with very low scores; and a group of eight intermediate banks. These groups were also labelled as: **"core domestic banks"**, **"non-core domestic banks"** and **"international banks"**. The category "core domestic banks" consists of a set of banks which have strong

Chart 1
REPRESENTATIVENESS
(per cent)



Source: Central Bank of Malta.

1 The choice of weights was based on a subjective but realistic assessment of the relative importance of each criterion.
2 Based on data as at end-September 2011.
3 Standardisation was determined on the basis of how each bank compares in relative terms with the bank having the maximum value of each specific criterion.

Table 1
SIZE AND LIST OF BANKS UNDER EACH CATEGORY

Core domestic banks	Non-core domestic banks	International banks
APS Bank Limited	BAWAG Malta Bank Ltd	Akbank T.A.S.
Banif Bank (Malta) plc	Credit Europe Bank N.V. Branch Malta	CommBank Europe Limited
Bank of Valletta plc	FIMBank plc	Deutsche Bank (Malta) Limited
HSBC Bank Malta plc	IIG Bank (Malta) Ltd	Erste Bank (Malta) Limited
Lombard Bank Malta plc	Izola Bank plc	FCM Bank Limited
	Mediterranean Bank plc	Fortis Bank Malta Ltd
	Sparkasse Bank Malta plc	Investkredit International Bank plc
	Volksbank Malta Limited	NBG Bank Malta Limited
		Nemea Bank Ltd
		Raiffeisen Malta Bank plc
		Saadgroup Bank Europe Limited
		Turkiye Garanti Bankasi AS
		VoiceCash Bank Limited
Total assets (EUR billions)		
14,236.1	**4,947.4**	**31,943.6**
Total assets (as % of GDP)		
222.7	**77.4**	**499.6**

links with the domestic economy, and are thus more systemically relevant. These banks have a widespread branch network, provide a full spectrum of banking services and are core providers of credit and deposit services in Malta.[4] The "non-core domestic banks" play a more restricted role in the economy, as the volume of operations and the banking services they offer to residents are somewhat limited. In turn, "international banks" have virtually no links with the domestic economy. Table 1 lists the banks which are classified under each of the identified three groups. As at end of 2011, the aggregate size of the core domestic banks in relation to Malta's gross domestic product (GDP) was 223%, while the ratio for non-core domestic banks and international banks, was respectively, 77% and 500% of GDP. On the basis of the methodology applied, the core domestic banks amply satisfy the five criteria established for systemic relevance in a Maltese context, with each bank achieving over 90% representativeness (see Chart 1). They are thus the focus of the major part of the *Report's* analysis.

The insurance and investment fund sectors

With regard to the insurance sector, the following four indicators of systemic relevance were considered:

(i) whether the institutions were subsidiaries of core domestic banks;
(ii) the amount of domestic investment assets held;
(iii) the total gross premia written for risks situated in Malta;
(iv) the total gross claims paid for risks situated in Malta.

In the case of the investment funds sector three indicators were used:

(i) the extent to which the fund was managed by a core domestic bank;
(ii) the amount of resident assets that it held;
(iii) the proportion of resident shareholder units in each fund.

[4] The number of core domestic banks on which the main text of the *Financial Stability Report* 2011 is based is smaller than the sample of banks considered in previous *Financial Stability Reports*.

Table 2
LIST OF INSURANCE COMPANIES AND INVESTMENT FUNDS

Insurance Companies	Investment Funds
Atlas Insurance PCC Ltd	Amalgamated Investments SICAV p.l.c.
Citadel Insurance p.l.c.	APS Funds SICAV plc
Elmo Insurance Ltd	GlobalCapital Funds SICAV plc
GasanMamo Insurance Ltd	Global Funds SICAV p.l.c.
GlobalCapital Life Insurance Ltd	HSBC Malta Funds SICAV p.l.c.
HSBC Life Assurance (Malta) Ltd	HSBC No-Load Funds SICAV p.l.c.
Middlesea Insurance p.l.c.	HSBC Structured Funds SICAV p.l.c.
MSV Life p.l.c.	La Valette Funds SICAV p.l.c.
	LandOverseas Fund SICAV plc
	Malta Development Fund Limited
	Santumas Shareholdings p.l.c.
	Vilhena Funds SICAV p.l.c.
	Wignacourt Funds SICAV p.l.c.

With regard to the standardisation method applied to both insurance and investment fund sectors, this was similar to that adopted for banks but with an equal weighting used across the criteria considered.[5] Table 2 lists domestic institutions that were selected for each category. All insurance companies and investment funds that were selected are highly representative. In the case of insurance companies, these accounted for around 97% of the gross premia written and claims paid for risks situated in Malta, whereas the selected investment funds represented 100% of resident shareholder funds.[6]

[5] For each qualitative variable, the value was either 1 if that criterion was satisfied, or 0 if not.
[6] The list of domestic insurance companies and investment funds is identical to that considered in previous *Financial Stability Reports*.

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		
	2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011
Core FSIs												
Regulatory capital to risk weighted assets	13.46	12.89	13.45	32.59	29.77	29.43	34.24	111.80	119.52	24.15	57.72	57.49
Regulatory Tier 1 capital to risk-weighted assets	10.11	9.17	9.51	30.51	27.93	27.70	31.84	110.22	118.32	21.34	55.14	54.91
Non-performing loans net of provisions to capital	42.45	55.86	54.89	2.47	9.81	9.70	1.74	0.40	0.08	12.66	6.55	6.85
Non-performing loans to total gross loans	6.18	7.45	7.33	2.41	3.59	4.46	0.47	0.61	0.45	2.58	3.04	3.25
Sectoral distribution of loans to total loans:												
Agriculture	0.32	0.31	0.30	0.06	0.06	0.07	0.00	0.00	0.00	0.11	0.11	0.11
Fishing	0.16	0.13	0.12	0.00	0.00	0.00	0.00	0.00	0.00	0.05	0.04	0.04
Mining and quarrying	0.09	0.10	0.08	0.00	0.07	0.01	0.00	0.00	0.00	0.03	0.04	0.03
Manufacturing	3.82	3.48	3.30	0.33	0.29	0.34	0.00	0.00	0.00	1.32	1.13	1.21
Electricity, gas, steam and air conditioning supply	4.87	5.50	5.70	0.07	0.09	0.10	0.00	0.00	0.00	1.65	1.76	2.06
Water supply; sewerage waste management and remediation activities	0.82	0.78	0.76	0.00	0.00	0.00	0.00	0.00	0.00	0.28	0.25	0.27
Construction	10.73	12.92	12.41	0.18	3.96	4.57	0.00	0.00	0.00	3.63	4.46	4.84
Wholesale and retail trade; Repair of motor vehicles and motor cycles	10.02	10.19	9.91	0.41	0.64	1.22	0.00	0.00	0.00	3.41	3.30	3.67
Transportation and storage	6.05	4.60	4.63	1.02	1.05	1.08	0.00	0.04	0.05	2.13	1.58	1.78
Accommodation and food service activities	5.33	5.54	5.50	0.01	0.23	0.10	0.00	0.00	0.00	1.79	1.79	1.99
Information and communication	0.29	1.45	1.37	0.05	0.04	0.06	0.00	0.00	0.00	0.10	0.47	0.50
Financial and insurance activities	0.39	2.21	2.12	0.21	0.19	0.39	0.04	0.00	0.00	0.17	0.72	0.80
Real estate activities [includes inputed rents of owner-occupied dwellings]	7.96	4.17	4.05	6.19	2.80	3.13	0.00	0.00	0.00	3.29	1.57	1.71
Professional, scientific and technical activities	3.28	0.85	0.72	0.20	0.05	0.06	0.00	0.00	0.00	1.12	0.28	0.26
Administrative and support service activities	0.24	1.11	1.13	0.00	0.46	0.52	0.00	0.00	0.01	0.08	0.39	0.45
Public administration and defence; Compulsory social security	1.46	1.49	1.47	0.00	0.00	0.00	0.00	0.00	0.00	0.49	0.47	0.53
Education	0.29	0.31	0.41	0.00	0.00	0.00	0.00	0.00	0.00	0.10	0.10	0.15
Human health and social work activities	0.49	0.47	0.54	0.00	0.00	0.28	0.00	0.00	0.00	0.17	0.15	0.22
Arts, entertainment and recreation	0.82	0.48	0.51	0.08	0.34	0.36	0.00	0.00	0.00	0.28	0.18	0.21
Other services activities	0.00	0.34	0.36	0.00	0.02	0.03	0.00	0.00	0.00	0.00	0.11	0.13
Households and individuals (excluding sole proprietors)	41.24	41.94	42.95	0.90	0.67	0.75	0.00	0.00	0.01	13.96	13.42	15.52
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	1.34	1.63	1.65	90.29	89.02	86.95	99.96	99.95	99.94	65.83	67.69	63.51
Return on assets	1.60	1.40	1.27	3.07	1.33	0.58	1.69	1.09	1.16	1.80	1.20	1.13
Return on equity	26.56	22.38	19.57	14.77	4.35	1.88	22.60	3.07	3.89	11.80	5.00	5.14
Interest margin to gross income	62.43	70.66	72.40	36.03	63.39	70.43	45.56	62.05	89.00	49.81	66.01	79.11
Non-interest expenses to gross income	48.43	49.66	54.15	16.49	35.45	45.37	14.90	8.32	9.17	26.72	30.08	34.28
Non-interest income to gross income	37.57	29.34	27.60	63.97	36.61	29.57	54.44	37.95	11.00	50.19	33.99	20.89
Liquid assets to total assets	22.27	24.93	24.10	14.06	10.86	14.68	8.28	5.76	7.41	16.46	15.09	16.12
Liquid assets to short-term liabilities	41.17	42.85	44.08	128.98	82.86	90.74	92.36	86.13	112.43	47.53	47.83	49.61
Other FSIs												
Coverage ratio	21.95	19.83	19.70	84.27	31.73	36.93	63.80	76.00	107.67	31.82	27.72	28.45
Domestic investment securities to total assets	11.87	12.28	12.76	2.85	2.23	2.24	0.00	0.00	0.00	3.96	3.55	3.77
Foreign investment securities to total assets	13.17	11.90	11.46	27.00	35.13	36.11	27.79	28.75	31.50	23.19	24.81	26.36
Unsecured loans to total lending	19.58	20.02	19.79	65.37	54.69	39.50	39.44	56.05	54.24	35.21	44.46	40.64
Assets to total capital and reserves (*)	16.10	15.78	15.52	3.42	4.12	4.19	4.17	1.60	1.56	3.93	1.88	1.85
Large exposures to capital	143.87	144.86	138.55	86.26	72.86	130.43	45.80	6.02	5.37	76.95	24.09	28.24
Gross liability position in financial derivatives to capital	1.42	2.18	4.91	0.16	0.68	1.49	0.18	0.45	0.42	0.44	0.64	0.99
Gross liability position in financial derivatives to capital	5.01	7.88	11.64	0.34	1.06	2.42	0.32	0.10	0.12	1.35	0.94	1.56
Personnel expenses to non-interest expenses	57.46	55.61	52.41	32.68	34.52	35.86	6.33	19.09	20.14	40.95	47.99	46.20
Customer deposits to customer loans	135.52	141.74	137.51	27.27	38.16	55.61	52.63	81.94	71.93	79.94	102.58	99.77
Net open position in equities to capital	14.32	16.07	17.88	77.04	80.38	78.68	3.68	0.84	0.89	17.59	7.09	7.71

(*) expressed as a ratio.

Glossary

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

Collective provisions: provision charges for potential unidentified future losses.

Cash ratio: the proportion of actual cash, balances with credit institutions and excess reserves held with the Central Bank of Malta as a proportion of short-term liabilities.

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

Covered bonds: debt securities backed by cash flows from mortgages or public sector 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.

EU–IMF Programme countries: countries which have made use of the EU-IMF bailout fund, namely Greece, Ireland and Portugal.

Interest burden: all interest payments excluding repayment of principal.

Interest rate margin: the difference between the weighted average interest rate on loans and the weighted average interest rate on deposits.

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.

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%. 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. Short-term liabilities are also specified in the Rule and 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.

Loan loss provisions: collective provisions and specific provisions.

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

Loss rate: assets in default as a proportion of total assets.

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.

Minimum reserve requirement: funds that banks must hold with the national central bank according to Regulation (EC) No. 2818/98 of the European Central Bank of 1 December 1998 on the application of minimum reserves (ECB/1998/15).

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.

Rescheduled loans: a credit facility which has had its terms and conditions amended so as to avoid default.

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.

Securities Market Programme: interventions by the Eurosystem in public and private debt securities markets in the euro area to ensure depth and liquidity in those market segments that are dysfunctional. The objective is to restore an appropriate monetary policy transmission mechanism, resulting in the effective conduct of monetary policy oriented towards price stability in the medium term. The impact of these interventions is sterilised through specific operations to re-absorb the liquidity injected and thereby to ensure that the monetary policy stance is not affected.

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 between 2012 and 2014 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.

Voluntary debt swap programme: an agreement with private holders of Greek government bonds to accept a bond swap with a 53.5% nominal write-down, partly in favour of EFSF notes, and new Greek bonds with lower interest rates and maturities of between 11 and 30 years.

VIX: the Chicago Board Options Exchange Market Volatility Index. This measures the implied volatility of S&P 500 index options.

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