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FINANCIAL STABILITY REPORT UPDATE – JUNE 2010

This update evaluates developments since the publication of the Financial Stability Report 2009 to determine whether identified threats to financial stability have increased, remained the same or subsided, and whether new risks have emerged.¹

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The Financial Stability Report (FSR) 2009 had concluded that the Maltese financial system was resilient but was likely to face challenges in the short- to medium-term. The magnitude of these challenges was dependent on the strength of the economic recovery. The FSR had judged that the risk outlook for financial stability, although remaining stable, was uncertain due to weak and uneven growth prospects. These conditions were thought likely to heighten the credit risk facing the banks, as downward pressures on households' and corporates' income generation impacted negatively on their capacity to service their debts. Against this background, the Report expressed some concern about the adequacy of loan loss provisioning by banks. Compounded with the high concentration risk related to the property sector, and potentially softer property prices, it was anticipated that banks would continue to reassess their risk appetite without creating significant deleveraging effects. Further uncertainty in the evolution of the risk outlook was attributed to the then emerging sovereign risk crisis. This was characterised by a dramatic widening of spreads on government bonds and sovereign credit default swaps of many euro area countries, which gave rise to a further wave of valuation losses on assets marked-to-market. At the same time, the long-term profitability and business models of financial institutions were being reassessed worldwide in view of the global regulatory reform proposals, targeted primarily towards strengthening bank capital and liquidity positions.

During the first half of 2010, stronger economic growth was expected to have a positive impact on the repayment capacity of the domestic corporate sector. On the other hand, credit institutions registered lower profitability compared to the previous period, while the extent of loan repayment by the household sector deteriorated somewhat. In the EU, while the recovery has also shown signs of consolidation, any renewed weakening would likely exacerbate credit risks as repayment capacities would weaken further. Indeed, the implementation of austerity measures in many countries could have negative repercussions on the Maltese economy. Renewed turbulence in the financial markets also suggests that the international financial crisis is not over yet. Overall, the risk outlook for financial stability thus remains stable but uncertain.

Macroeconomic conditions have improved somewhat, but remain uneven as downside risks to growth persist while financial markets are still fragile

The global economy has rebounded in recent months but the recovery remains fragile and subject to downside risks.² Growth in the euro area is forecast to remain modest in 2010 and 2011 at 1.1% and 1.4%,

¹ The cut-off date for information published in this Report is 6 August 2010.

² Macroeconomic forecasts are based on *Consensus Forecasts July 2010*.

respectively. On the other hand, a relatively stronger rebound in the United Kingdom, and in particular in the United States, is being projected at 1.3% and 3.1% for 2010, and at 2.1% and 3.0% in 2011, respectively. Unemployment rates over the forecast horizon are expected to remain about 10% in the euro area and the United States, and 5% in the United Kingdom. In the near term, the absence of inflationary pressures should continue to enable major central banks to maintain official interest rates at current low levels. The economic outlook thus remains uncertain, especially since a number of countries are implementing rigorous austerity measures.

The accentuation of sovereign risk in the first half of 2010 has led to deterioration in market sentiment. Market liquidity again dried up for a number of financial institutions that were perceived to be exposed to such risks. Markets became volatile, and confidence diminished. Following a number of international initiatives, including the setting up of a European Financial Stabilisation Mechanism and the European Financial Stability Facility, as well as the provision of non-conventional support by central banks, including the outright purchase of government securities, the imminent risk of sovereign default has abated but risk premia in a number of countries still remain high.^{3, 4}

The Maltese economy has rebounded faster than expected, but challenges remain

During the first quarter of 2010 real GDP rose by 3.4% on a year earlier, underpinned by brisk export activity and an accumulation of inventories. The recovery was accompanied by a general improvement in business confidence that extended into the second quarter of the year. However, private consumption growth moderated. Although Labour Force Survey (LFS) data show that overall employment continued to expand on a year earlier, the increase was entirely in the part-time and reduced-hours categories, as the number of full-time jobs dropped.

Growth projections have nevertheless improved somewhat from 1.2% to 1.5% in respect of 2010, while the forecast for 2011 has remained unchanged at 1.8%. Domestic demand is expected to remain subdued. Downside risks are therefore likely to persist particularly as labour market conditions are expected to remain challenging, with unemployment rates hovering in the region of 7%.

The rebound in exports has had a positive influence on corporate profitability. Indeed, during the first quarter of 2010 the economy-wide operating surplus jumped by almost 17%, admittedly from a relatively low base. The positive trend is further corroborated by the industrial confidence indicator, which swung into positive territory in June and remained so in July.⁵ However, the recovery is not broad-based. While the manufacturing and the wholesale & retail trade sectors reported a higher operating surplus, the hotels & restaurants sector again had a negative operating surplus and the decline in the surplus of the construction sector, in evidence since the beginning of 2009, extended further. Indeed, according to the semi-annual survey conducted by the Bank, conditions in the property market, particularly in those segments with significant oversupply, remain weak, characterised by a subdued volume of transactions and virtually stable house prices. The latter, combined with the fact that the number of building permits issued during the first half of 2010 declined by around one-fifth, suggests a convergence to a better balance in the property market.⁶

Going forward, it is expected that corporate profitability will be sustained at current levels, confirming the incipient improvement in financial conditions. Credit risk is thus expected to decline slightly, but some downside risks, associated with a possible weakening in the global economic recovery, persist.

³ The European Financial Stability Mechanism (EFSM) was established by an agreement of the European Finance Ministers in ECOFIN on 9 May 2010 in order to financially support Member States in difficulties caused by exceptional circumstances beyond Member States control.

⁴ The European Financial Stability Facility (EFSF) has been created for three years and is the main part of the €750 billion aid package that European Finance Ministers agreed upon in June 2010. The EFSF has the capacity to issue bonds guaranteed by the euro-area Member States for up to €440 billion. Funds will be used to loan to euro-area Member States that find themselves difficulties at the state level. The Maltese Government has committed itself through a guarantee to the amount of €398.44 million (Act no XIV of 20 July 2010).

⁵ Source: European Commission.

⁶ Source: MEPA.

The household sector also continues to face pressure. Although in some industries income generation maintained a positive momentum, in others, including the manufacturing and construction sectors, these declined such that the economy-wide compensation of employees fell for the third consecutive quarter on an annual basis.

Corporate and household indebtedness rose further in spite of tight credit conditions

The indebtedness of the resident corporate sector grew by €91 million (1.8%) since December 2009.⁷ This was virtually equally split between additional bank loans and net bond issues. However, the rate of borrowing from banks decelerated further to 0.9% in the first six months of 2010 against 5.6% in 2009.⁸

As a result of higher earnings and liquidity, the debt servicing capacity of the corporate sector improved slightly during 2010 despite an increase in the average borrowing rate from 4.8% to 5.0%, the latter reflecting the reassessment of risk by banks.⁹

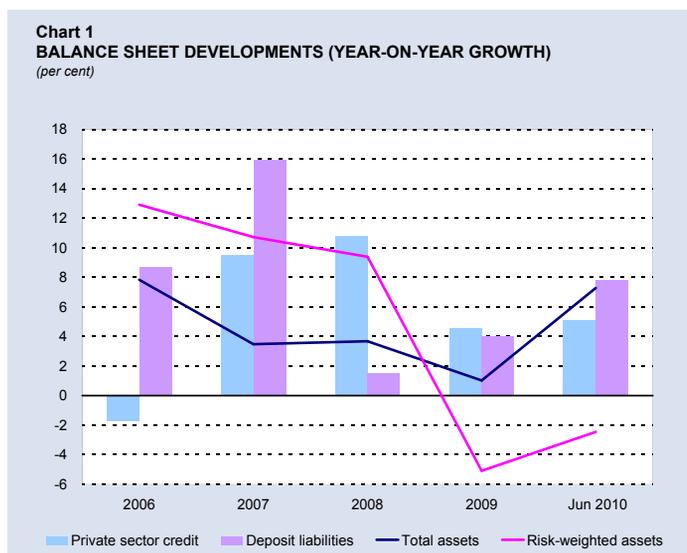
Household credit growth also decelerated during the first half of 2010 to 3.3%, down from 4.9% in the comparable period of 2009. The new credit was predominantly for mortgage purposes, which expanded by 4.2%, with consumer credit growing by only 0.2%.¹⁰ The overall mortgage interest burden however eased, as in contrast to the corporate sector the weighted average borrowing rate declined from 3.9% to 3.6%, while net financial wealth expanded by 2.6%. The latter took place in spite of an adverse trend in the prices of equities listed on the Malta Stock Exchange (MSE) which lost 2.8% in the first six months of 2010, before rebounding significantly thereafter to grow by 0.8%.

Banks expanded their balance sheets and risk-weighted assets remained below last year's levels

Bank balance sheet growth regained momentum during 2010, expanding by 7.6% (Chart 1). The expansion took place primarily via inter-bank exposures (including intragroup and repos) with parent/sister companies within the group structure. This contributed to just over a third of the balance sheet growth, and raised total interbank exposure to 134% of own funds. At the same time, the banks' investment portfolio increased by over 9%, skewed towards additional domestic and foreign sovereign bonds in lieu of foreign private bonds. The aggregate sovereign bond exposure to Greece, Portugal and Spain was equivalent to almost 10% of total own funds, of which around a quarter classified in the 'Available for Sale' category and hence influenced by changes to market prices.¹¹

Total non-performing loans stabilised at elevated levels, with divergent trends in the case of corporate and household

There has been a clear upward (and rapid) trend in non-performing loans (NPLs) since the first quarter of 2008, cumulatively increasing by 35%. More recently, this trend slowed down somewhat, with total NPLs rising by



⁷ Corporate intergroup debt is not included in the calculation of corporate indebtedness.

⁸ As a result of a break in series following reclassification of economic sectors, for the purpose of the calculation credit growth against 2009 figures (restated at 5.6%), the corporate sector includes both the non-financial corporates and the financial intermediaries.

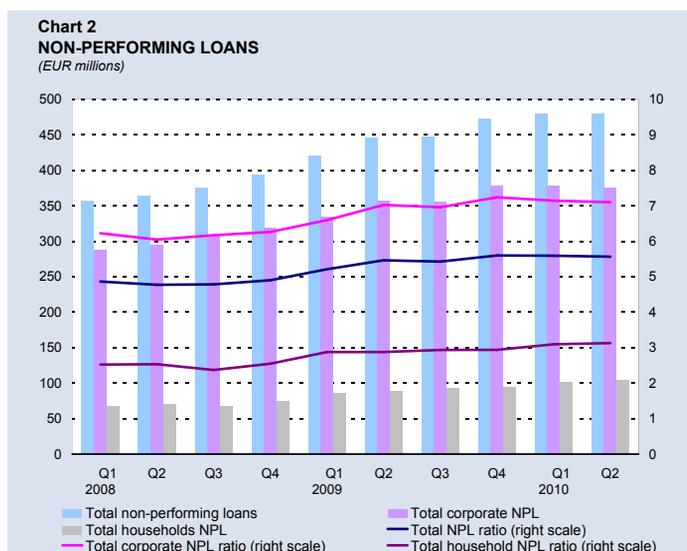
⁹ Deposits by the corporate sector increased during the period under review.

¹⁰ The average mortgage size rose by 2.3% to almost €49,000 during the first six months of 2010.

¹¹ The credit ratings for these countries have been downgraded during 2010.

€6.5 million to just under €480 million by the end of June 2010 (Chart 2). The overall NPL ratio stabilised at 5.6%. Gross problematic assets remained stable at 7.4% as at end 2009.¹²

After peaking at the end of 2009, corporate non-performing loans (NPLs) declined for two consecutive quarters.¹³ The overall corporate NPL ratio remained stable at elevated levels (7.1% as at June 2010 against 7.2% as at December 2009), suggesting that despite the slight improvement, banks are still vulnerable to corporate credit risk. Indeed, 9 insolvencies were declared during the first half of 2010 compared to 11 for the whole of 2009.



The NPL ratios of the accommodation & food services activities (previously referred to as the hotels & restaurants sector) and the wholesale & retail trade sector remained high at around 11.5% and 10.5% respectively. There may be additional systemic concerns in respect of the accommodation & food services activities as this sector also represents over a third of the equity and domestic corporate bond market (excluding the banking sector). Likewise, the NPLs of the construction and real estate activities sectors remained high at around 10% and 7.5% respectively. Additionally, rescheduled facilities increased by a further 3.7%, driven mainly by loans to the construction sector.

Overall developments in the household sector were insufficient to halt the trend increase in household NPL ratio, which increased to 3.1% as at June 2010 (December 2009: 2.9%). The evolution in household NPLs gives rise to some concern. These expanded by almost 10% during the first six months of 2010 and are some 50% higher than as at March 2008.

On balance, although the non-performing ratio stabilised at 5.6%, it is premature to conclude that the peak has been attained, particularly due to the evolution of household NPLs as well as due to the fact that NPLs tend to follow economic developments with a lag. Indeed, during the first six months of 2010, the weak credit quality environment induced banks to increase their loan loss provisioning by a larger extent than NPLs in order to enhance their shock absorbing capacity. As a result, the coverage ratio (loan loss provisions and collateral as a proportion of NPLs) increased from 93% as at end 2009 to 96% by June 2010.

Valuation losses offset the recovery in net interest income

During the first half of 2010, aggregate bank profits amounted to €89 million (Chart 3). The banks' return on equity (ROE) declined to 14.2% (2009: 20.2%) while their return on assets (ROA) dropped from 2.1% to 1.5%.¹⁴ In both instances the dispersion across banks remains significant. The ROE weakened largely as a result of lower operating efficiency and productivity. The reduction in profits was largely the result of higher loan loss provisions and, to a lesser extent, higher staff costs. On the other hand, the banks' net interest income improved as a result of a steeper fall in interest expenses than in interest earnings. Banks continued to benefit from the downward re-pricing of their deposits while the spread between deposit and lending rates widened to 3.2 percentage points, reflecting also the tighter credit standards. The availability of ECB funding at record low interest rates also contributed to the improvement in net interest income. The take up of such

¹² Gross problematic assets combine the value of NPLs with the amount of rescheduled facilities.

¹³ In view of some data reclassification across sectors it is not possible to determine with certainty the source of these drops.

¹⁴ The ratios are based on the last 12 months between July 2009 and June 2010.

facilities, at only 4% of short term liabilities compared with 5.1% in December 2009, remained, however, driven by normal treasury operations.

The banks' funding structure remains robust, but continues to rely on short-term deposits

Retail deposits continued to underpin the banks' funding structure. Despite the relatively low interest rates on offer compared to recent years and strong issuance of corporate and sovereign bonds, customer deposits still grew faster than customer loans. The corporate sector accounted for almost two-thirds of the overall increase in customer deposits, extending a pattern noted during the previous six

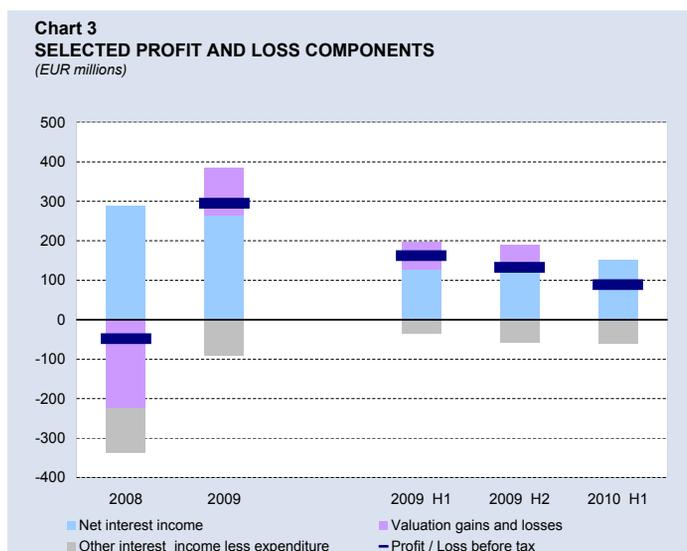
months. Of these some 30% originated from non-resident depositors and are generally more volatile. As a result, the customer deposit-to-loan ratio improved by 4 percentage points to 130%. At the same time, the maturity structure remained highly concentrated in short-term deposits, with the share of current and savings accounts accounting for 52% of deposits.¹⁵ Still, funding risks are generally low since reliance on market funding is limited. Interbank funding remains predominantly derived from the parent or sister companies within the banking group. Since the take up of ECB funding is low, the eventual scaling back of the Euro-system's non-standard measures should pose no significant threat. Moreover, the refinancing obligations in terms of maturing bank bonds over the next two years are limited to about €29 million.

In the period under review, banks increased their liquid asset holdings by over 26%, almost a quarter of total assets. The liquidity ratio thus improved further, to 50%, compared to a regulatory minimum of 30%. The asset composition remained characterised by a significant home bias, with Malta Government Stocks (MGS) and domestic Treasury bills making up almost half of the total. The composition changed slightly, however, as banks invested more in Treasury bills than in MGS, suggesting a preference for short-term assets in anticipation of an eventual increase in interest rates from their currently low level.

Capital adequacy ratios (CAR) weakened but remained significantly above the regulatory minimum

The banks' CAR weakened slightly, from 15.9% at the end of 2009 to 14.8% in June 2010 (Chart 4).¹⁶ Similarly, the Core Capital Adequacy Ratio (CCAR), predominantly composed of ordinary share capital and retained earnings, dropped from 13.0% to 11.7%.¹⁷ These developments reflected a contraction in total own funds stemming from adjustments and higher prudential filters as a result of regulatory changes implemented as from 2010. Such changes help improve the overall quality of the banks' measured capital. The decrease in the regulatory ratio also reflects an increase of 1.8% in risk weighted assets during the first six months of 2010.

In spite of a decrease in both the CAR and CCAR, the univariate stress tests conducted for the period ending June 2010 confirm the overall resilience of the banking sector to extreme but plausible shocks. Indeed the impact of the house price shock on the banking sector was somewhat lower during the period under investigation largely due to an increase in collateral held by the banks. When compared with the Decem-



¹⁵ Although in theory such deposits can be withdrawn on demand and can thus be highly mobile, in practice these deposits have tended to be rather sticky. Higher competition for deposits may however increase their mobility.

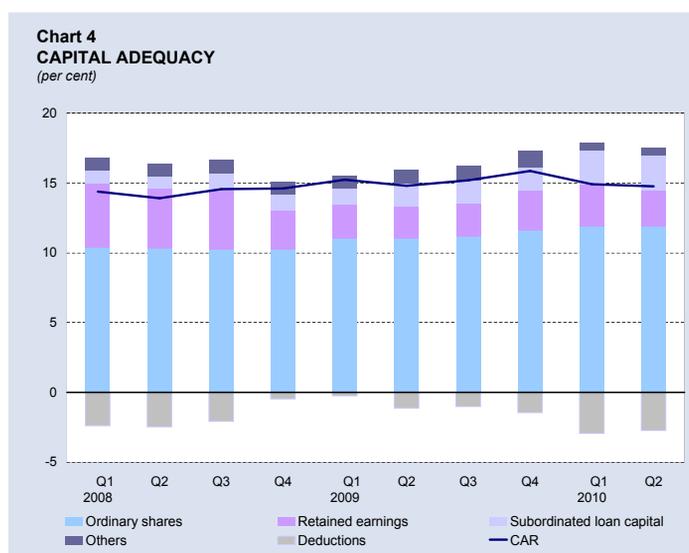
¹⁶ The regulatory minimum for the CAR is 8%.

¹⁷ The regulatory minimum for the CCAR is 4%.

ber 2009 results, the effect of a credit rating deterioration and economic downturn would remain broadly at the same levels of December 2009. Resilience to the liquidity shock would improve somewhat even under the most extreme scenario of 20% deposit withdrawal mainly as a result of an increase in liquid assets. In fact, in aggregate the banks would remain liquid throughout the survival period.¹⁸

Bank of Valletta plc and parent banks of domestic subsidiaries successfully passed the EU-wide CEBS stress test

The banks participating in the EU-wide stress test were chosen on the basis of the criteria set out by the ECB and the CEBS, which required a minimum coverage of 50% of the banking system in terms of assets for each Member State.¹⁹ The stress testing exercise was conducted on the basis of parameters and scenarios that were jointly set by CEBS and the ECB and was based on adverse yet plausible shocks tailored to the economic circumstances of each participating Member State. This consisted in the choice of negative shock factors to be applied to the various components of the balance sheet and income statement. The results, which were based on a top-down framework (strictly interpreted as 'what-if' type of scenarios), indicated that Bank of Valletta plc to comfortably exceeded the established threshold of 6% Tier 1 capital (CCAR) ratio, even when all adverse shocks were assumed to materialise simultaneously. Likewise, all the parent banks of domestic subsidiaries included within the sample passed the test. The subsidiaries included within their Group results were HSBC Bank Malta plc, Raiffeisen Bank Malta plc, NBG Bank Malta Ltd, Erste Bank (Malta) Ltd and Fortis Bank Malta Ltd.



The insurance sector reverted to profitability while the remainder of the non-bank financial sector expanded further

The insurance sector reverted to profitability during the first quarter of 2010.²⁰ This contrasted sharply with the losses incurred during the preceding six months as a result of the writing-off of the operations of a foreign subsidiary. At the same time, the underlying performance was healthy. During the first quarter, the insurance sector asset base expanded by 6.6%, with the business mainly being driven by the life assurance segment. Premia from the non-life segment also increased. In addition, the insurance sector reported higher investment income earnings. In terms of solvency, the life segment maintained a stable ratio of around 13%, while that of the non-life sector deteriorated somewhat from 37.8% to 33.9% as a result of a faster growth in assets than capital. The risks associated with the insurance sector remain driven by the endemic features of this sector, namely: the persistent high risk retention ratios (97% in the case of life business and 69% in the case of general business); high concentration in the investment portfolio; a highly concentrated market having an HHI (Herfindahl-Hirschman Index) of 3805; and close linkages with the banking sector.

In turn, the size of the investments sector, which consists of collective investment schemes (CIS) (12 in total) and hedge funds (7 in total), remained small, respectively equivalent to less than 5% and 1% of the financial sector. Assets managed by CIS, predominantly focused on MGS and private foreign securities, expanded by 3.7%, while those managed by hedge funds increased by 1.3%, in the latter case reversing further the drop since the peak of the global financial crisis.

¹⁸ The liquidity stress test is carried out over a 5-day period where banks are expected to remain liquid.

¹⁹ For further information refer to http://www.centralbankmalta.org/site/stress_tests.html and the links therein.

²⁰ Data for the insurance sector is only available as at March 2010.

Broad agreement reached on the proposed international regulatory changes

At its mid-July 2010 meeting the Basel Committee on Banking Supervision (BCBS) reviewed the design and overall calibration of the proposed capital and liquidity frameworks in the light of the results of the quantitative impact assessment (QIS) and the comments submitted by market participants.²¹ Based on these evaluations, the oversight body of the BCBS reached a broad milestone agreement on the reform package. In particular, this related to the definition of capital, counterparty credit risk, design and calibration of the non-risk based leverage ratio, regulatory buffers, loan loss provisions and liquidity. Regarding the liquidity coverage ratio, it was agreed to recalibrate the stress scenarios and revise the definition of a qualifying liquid asset. The net stable funding ratio (NSFR) will be modified to take into account the calibration of the standard and banks' business models. In its calculation of the NSFR, the BCBS will also be considering whether to recognise matched funding within a one-year time frame. The new liquidity framework is expected to be adopted in 2018.

The BCBS has issued another consultative document regarding proposals relating to the countercyclical capital buffer. This buffer is considered as a consistent instrument in the suite of macro-prudential tools to be developed when excess aggregate credit growth is judged to be associated with a build up of system-wide risk. In the case of *systemic banks*, further work is being considered to address the initiative proposed by the Financial Stability Board (FSB).

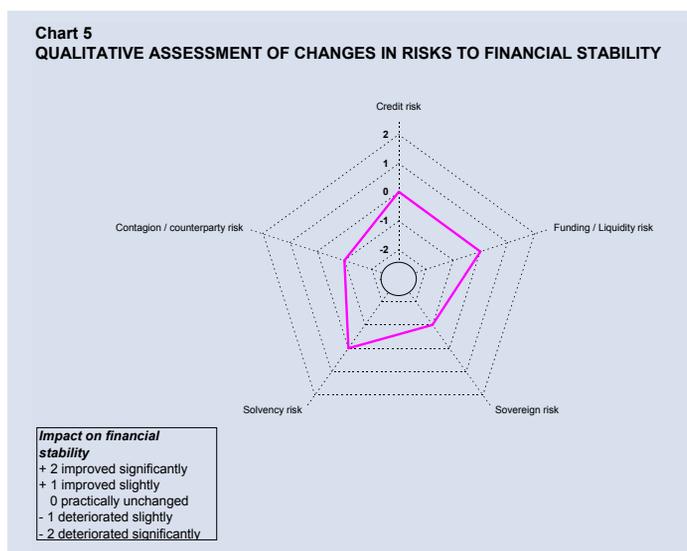
It is expected that the issues relating to the regulatory buffers will be finalised before the end of 2010 with the calibration and the phase-in arrangements being in place by September 2010. The plan is to present a final package of reforms to the G-20 leaders meeting in Seoul in November 2010. It is expected that the new regulations will be implemented gradually as from 2012.

It is not currently possible to estimate the direct impact of these regulations on the solvency and liquidity ratios of banks in Malta. However, an interim assessment issued by the FSB and the BCBS on the macroeconomic impact of the transition to stronger capital and liquidity requirements suggests only a modest impact on aggregate output.²²

Updated risk outlook

Although underlying risks have changed to a small degree, the overall outlook for financial stability remains stable and broadly in line with that outlined in the 2009 FSR (Chart 5). While economic activity has picked up both abroad and in Malta, the financial system remains susceptible to any weakening in the recovery, which could give rise to further credit risk. A new development has been the market turbulence experienced in recent months centred on heightened sovereign risk.

While the performance of the corporate sector is expected to remain at the improved level experienced during the last twelve months, it still faces significant challenges emanating in particular from feeble economic growth in Malta's export markets. The



²¹ Refer to document "The Group of Governors and Heads of Supervision reach broad agreement on Basel Committee capital and liquidity reform package" available on <http://www.bis.org/press/p100726.htm>

²² Refer to document "Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements" available on <http://www.bis.org/press/p100818.htm> published on 18 August 2010.

construction industry will also likely remain subject to further downward adjustments. The repayment capacity of the household sector has decreased and in the short-term, subject to economic and financial conditions remaining stable, no further reductions in debt servicing costs are anticipated.

Possible vulnerabilities relating to corporates and households alike may be currently masked by the current low interest scenario.

In the near term, given the high concentration risk within the banks' portfolio and the need to continue to strengthen loan loss provisioning levels, credit risk will remain high. Any setback in economic recovery could translate into an immediate and material credit risk, as in some cases the resilience of the non-financial sector has weakened. Enhanced risk management practices and more realistic pricing of risk should, however, ensure better quality in the banks' loan portfolio.

Banks remain sufficiently resilient with a high, albeit decreasing, core capital. While higher loan loss provisioning could dilute some of this capital, this would however ensure longer-term stability. Improving net interest income should offer further support, provided dividend policies remain conservative. Indeed, it remains imperative that banks preserve strong capital buffers, particularly at a time when funding conditions are more favourable. This is particularly important since the proposed new regulatory regime, though allowing for ample transition periods, may be more onerous both in terms of capital requirements and of the costs of doing business. On balance, banks' capital and resilience to shocks are expected to remain robust in the foreseeable future.

Liquidity risk continues to be low and is expected to remain so. Sovereign risk has increased significantly in the last months and the associated market turbulence has heightened contagion risk. However, the measures taken by the ECB and the EU have helped to reduce market tensions. It remains imperative that governments take appropriate steps to put public finances on a more sustainable footing.

On balance, the financial stability outlook remains stable but subject to uncertainty. It is conditioned by the concentration weaknesses that characterise the Maltese banking sector, particularly on the asset side, in view of the dominance of property-related loans. At the current juncture, therefore, credit risk remains the prime financial stability concern.