BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

FINANCIAL STABILITY REPORT ~ UPDATE JUNE 2009

This update evaluates developments since the publication of the Financial Stability Report 2008 to determine whether identified threats to financial stability have increased, remained the same or subsided, and whether new risks have emerged.[1]

This update has been adopted by the Bank's Financial Stability Committee.

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The Financial Stability Report 2008 had highlighted increased vulnerability to macroeconomic developments as the main risk facing the domestic financial system. Losses were expected to increase due to a rise in non-performing loans, as both the household and the corporate sectors found it increasingly difficult to service their debts. Other risks identified in that Report were those stemming from the system's asset concentration and a potential sharp price correction in the property market. The outlook for 2009 was for banks to face a rise in non-performing loans and a fall in profitability. Market risks were expected to last longer, while risks to the non-bank financial sector were expected to intensify. Overall, on account of the increasingly uncertain economic environment, the domestic financial system was considered to have become more vulnerable.

International macroeconomic conditions have deteriorated further, exerting a larger downward effect on domestic economic activity.

Since the publication of the Financial Stability Report 2008, external macroeconomic conditions in the March 2009 quarter deteriorated more than was originally projected with indications in the second quarter of the year that the pace of global economic slowdown was decelerating. Notwithstanding, updated forecasts suggest that in 2009 an overall contraction in the major economies is likely to take place, with the euro area's GDP expected to fall by between 4.1% and 5.1% and that of the United Kingdom and the United States by 4% and 2.6%, respectively.[2] World trade is expected to shrink by an even sharper 10% or more.[3] At the same time, resulting job losses extended the upward trend in unemployment. In the case of the euro area and the United States, unemployment rates edged closer to 10% and are expected to rise further in the near term. Meanwhile, inflation rates eased worldwide, in some cases even turning negative on account of the base effects related to energy prices. This scenario enabled the major central banks to continue with their accommodative monetary policy stance, lowering interest rates to historically low levels and complementing this

[1] The cut-off date for financial information published in this Report is 22 July 2009 while for macroeconomic data it is 4 August 2009.
[2] Source: June 2009 Eurosystem staff projections and Consensus Forecasts July 2009.
[3] Source: IMF World Economic Outlook April 2009.

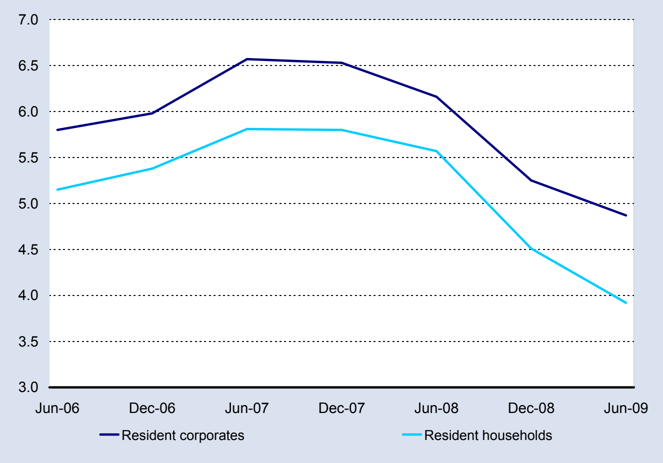
with credit support and quantitative easing measures. Concurrently, governments continued to counter the fall in demand with stimulus packages, incurring large fiscal deficits and raising public debt in the process.

The anticipated adverse knock-on effects on Malta's small and open economy are materialising, with the export-oriented industries being particularly affected. Indeed, during the first quarter of 2009 Malta's real GDP shrank by 3.3% year-on-year, while as at end-June the number of registered unemployed had exceeded 7,200, up by 24% on a year earlier. The global recession has also led to double-digit annual declines in both tourist arrivals and expenditures, while indications are that the critical summer period is unlikely to have mitigated this negative trend. Nevertheless, the recession in Malta may be less deep than elsewhere, as business confidence indicators have recently turned less pessimistic while revenue from income tax during the first six months of the year was still on the increase.[4] In the latter case, however, the cash-based indicator does not rule out the possibility of a delayed impact of current difficulties. In addition, idiosyncratically high inflation in Malta as a result of a delayed pass-through of lower international energy prices may continue to exert downward pressure on disposable income.

This is impinging on the debt servicing capacity of both corporates and households, while banks are tightening credit standards, but loan loss provisioning has not been increased accordingly.

The slowdown in domestic economic activity is being absorbed mainly by corporate profits. Indeed, national accounts data for the first quarter of 2009 show a decline in operating surplus across most sectors. This might indicate that some firms are hoarding labour resources on the assumption that the recession will not be prolonged. Uncertain growth prospects are, however, inducing firms to scale down their investment spending, cooling off the demand for credit. At the same time the corporate sector is benefiting, albeit not fully, from the cuts in official interest rates, as the weighted average borrowing rate has declined by 37 basis points since December 2008. Nevertheless, during the first six months of 2009 the ratio of resident corporate non-performing loans rose from 7.3% to 8.2%. Reflecting the unfavourable economic conditions in Malta's main markets, the most affected were the hotels and restaurant sector, where the non-performing loan ratio increased to 11.5% from 10.7%, and the manufacturing sector, where it rose to 11.5% from 9.5%. In the construction sector, the ratio rose to 9.9% from 8.5%, and it rose to 9.1% from 6.6% in the real estate, renting & business activities sector. In contrast, the non-performing loan ratio for the wholesale & retail sector, though still high, declined marginally, from 10.3% to 10.1%.

Chart 1
WEIGHTED AVERAGE BORROWING RATES
(percent)



Households' interest payments during the first six months of 2009 were less than in the corresponding period of 2008. The effect of a higher outstanding level of debt, both in terms of mortgages and other consumer credit, was more than offset by a decline in the weighted average interest rate paid by households (Chart 1). In spite of rising unemployment, aggregate nominal incomes are possibly still on the increase, as revenues from Final Settlement Tax are still on an upward trend. Still, going forward, households' resilience may diminish as their real incomes come increasingly under pressure from high inflation while their financial and

[4] The Central Bank of Malta's latest forecast points to a 0.6% contraction in real GDP in 2009.

non-financial wealth buffers have been partly eroded. Indeed, valuation losses on asset portfolios exceeded additions to households' deposit and bond holdings, depressing households' financial wealth, while falling house prices, estimated by the Central Bank of Malta to be in the region of 10% year-on-year as at end-March 2009, reduced the value of their housing wealth. Resident households are also finding it increasingly difficult to service their debts, as the increase in non-performing loans shows. The proportion of household non-performing loans has risen to 2.9% from 2.5%, as the ratios of mortgage and other credit non-performing loans rose from 2.1% to 2.4% and from 4% to 4.5%, respectively.

Despite the deteriorating quality of the banks' loan book, with overall non-performing loans increasing from 4.9% to 5.5% of their loan portfolio, the banks have cut general provisions, thereby marginally reducing their total loan loss provisions. Going forward, this implies greater risk within the banks' books as their aggregate coverage ratio (total provisions to non-performing loans) has gone down from 24.1% to 21.2%, and in some cases is significantly lower than that.

Similar to the majority of other euro area banks, however, the uncertain economic prospects, both general and sector-specific, have induced banks in Malta to review their lending practices. During the first six months of 2009, banks in general increased their margins with respect to both the household and the corporate sector to better reflect the inherent risks of the loans granted. In practice, this has translated into a more muted pass-through of official rate cuts to lending rates. The tightening process is expected to persist in the coming months as banks continue to review and to adjust the conditions attached to their client portfolio.

Despite a slowdown in credit growth, credit supply does not appear constrained.

Growth in the banks' balance sheet decelerated to 1.3% during the first six months of 2009. Lending expanded by 1.8%, a slower pace than the 4.9% growth recorded during the preceding six months. Although mortgage credit grew by around 5%, which is the same pace as in July – December 2008, growth in other consumer credit decelerated from 7% to 5%. In turn, corporate credit increased by only 1.1% as credit to the manufacturing sector was scaled down by 16.5%, though this mainly reflected a large loan repayment by a public non-financial company. Slower growth was also recorded in lending to all other sectors with the exception of the wholesale & retail and the hotels & restaurants sectors. The generally subdued pace of corporate credit growth coincided with the delaying of firms' investment projects and the consequent weaker loan demand - as reported by the major banks participating in the Bank Lending Surveys carried out during 2009.

No major changes were noted with regard to the sectoral breakdown of outstanding credit to residents during the first six months of the year. However, three-fourths of the additional resident credit provided during this period was channelled to households, a sign of possible risk aversion by the banks, while overall lending remained concentrated on property. Meanwhile, the overall value of the ten largest single name net exposures declined in absolute terms from the December 2008 level, as some large borrowers resorted to alternative funding through issues of bonds.

Banks added 6% to their securities portfolio, reflecting increased holdings of domestic and foreign government securities, complemented by a reversal of earlier price declines. In contrast, net inter-bank exposures with parent banks abroad have been scaled back since the beginning of the year. Similarly, interbank exposures between resident institutions declined, whereas interbank activity with other non-resident institutions increased. As a result, interbank exposures of domestic banks, which accounted for around 116.4% of total own funds of the banks, were down by 6 percentage points from end-December 2008.

Profitability has improved on account of valuation gains, which have more than compensated for the squeeze in net interest income

Chart 2
ROE AND ROA
(percent)

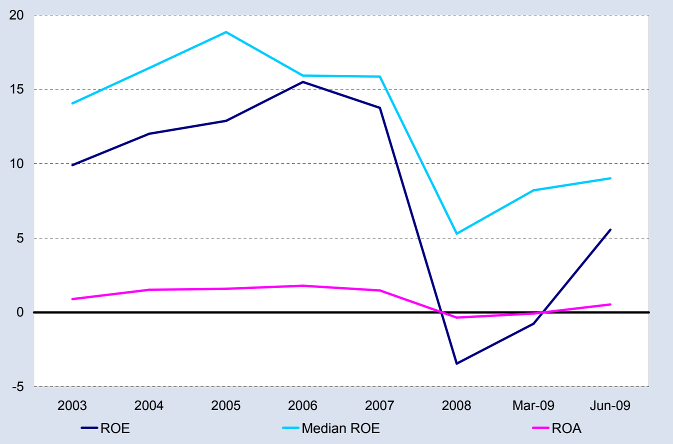
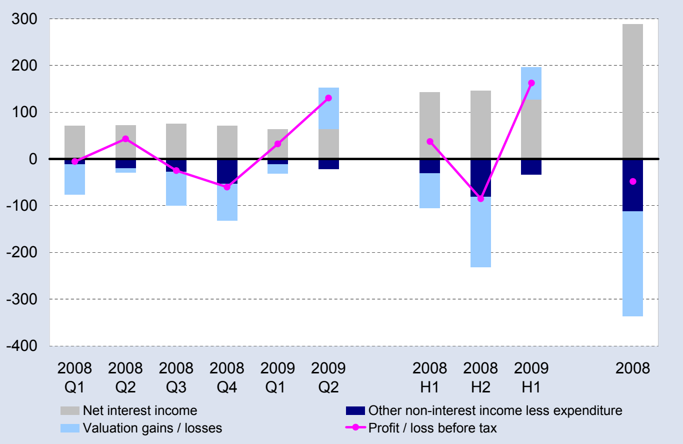


Chart 3
SELECTED PROFIT AND LOSS COMPONENTS
EUR Million



During the first six months of 2009, banks reported aggregate profits before tax of €162 million, significantly better than the €37 million reported for the corresponding period a year ago. As a result, the banks' average return on equity (ROE) swung back into positive territory, while the median ROE also improved (Chart 2).

The main movements were attributable to upward fair value adjustments during the first half of 2009 as against the losses suffered throughout 2008, especially during the second half of that year (Chart 3). In spite of these developments, however, bank share prices declined by a further 12.6% in the six months to June 2009, compared with an overall 8.4% decline in the MSE index over the same period.

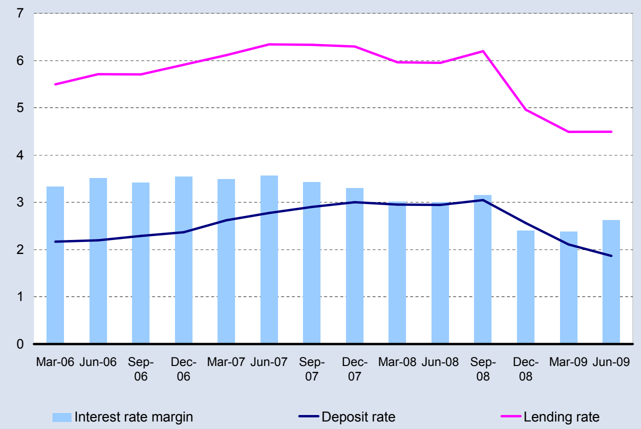
Net interest income was squeezed by more than 10% when compared to a year ago. In the second half of 2008 weighted average lending rates fell at a faster pace than deposit rates, but in the first six months of 2009 the trend was reversed as deposit rates fell faster than lending rates (Chart 4). In this respect, the banks have tended to manage their margins so as to achieve the twin objectives of a better pricing of risk and sustained profitability.

Capital ratios remained above the regulatory minima, while no significant changes in funding, liquidity and market risks were observed.

The banks' capital adequacy ratio (CAR) increased by 0.5 percentage points to 15% in the six months to June 2009. The majority of banks increased their own funds, in some cases through the issue of subordinated debt, while at the same time reducing their risk weighted assets. The core capital adequacy ratio (CCAR) meanwhile remained stable around 12.3%, as a drop in the original own funds of a single bank pulled the aggregate balance down.[5]

[5] Subsequent to the publication of the Financial Stability Report 2008, both capital adequacy ratios for December 2008 were revised downwards: the CAR from 14.9% to 14.5% and the CCAR from 12.9% to 12.4%.

Chart 4
INTEREST RATE MARGIN
(percent)



Banks continued to maintain 21% of their balance sheet total in the form of liquid assets, corresponding to 45% of their short term liabilities. At the same time, customer deposits continued to exceed loans by a buffer of around 26%. Although the average maturity of bank deposits increased marginally, as a number of banks issued special longer-dated term deposits, deposits remained concentrated mostly in the lowest time bucket. At the same time, an analysis of the one-month maturity mismatch shows a significant improvement, as total liabilities maturing by July declined by 5.4% while total assets maturing within the same month increased by 0.6%. Furthermore, duration analysis suggests that the banks' sensitivity to an interest rate shock has decreased. In addition, market risks remained contained.

Stress tests results remain broadly unchanged.

Repetition of the economic downturn and house price crash scenarios stress tests based on data as at June 2009 confirmed the banks' ability to withstand such extreme yet plausible shocks. In both cases, the downside impact on the CCAR was practically identical to that of the 2008 tests, with the after-shock ratio declining slightly to around 12%. On the other hand, the credit quality deterioration stress test exhibited a 0.3 percentage point stronger impact, as the weighted probability of default of current bank portfolios was estimated to be marginally higher than in December. This is because the impact of a higher proportion of substandard and doubtful loans in the banks' portfolio exceeded that of additions of Government securities. In the case of the liquidity stress test, modelled as a 5-day survival period with 15% consecutive deposit withdrawal, although results in aggregate were positive, not all banks passed the test.[6]

The non-bank financial sector continued to under-perform.

During the first quarter of 2009 there was an across-the-board reduction of about 10%, year on year, in premia underwritten by life insurance firms (which represent the larger segment of the market).[7] On the other hand, other non-life insurance premia were unchanged compared to a year ago. Meanwhile the insurance sector continued to record losses related to its investment activities, extending the trend noted since the second quarter of 2008. In aggregate these losses amounted to just over €6 million during the quarter. In addition the sector continued to be highly concentrated, with the life and non-life segments maintaining risk-retention ratios as high as 96% and 68%, respectively. The ratio of the sector's capital to its total assets decreased slightly, from 15.9% to 15.5%.

During the first quarter of 2009, assets managed by resident collective investment schemes, almost entirely belonging to households, contracted by a further €17 million, though the downward trend appeared to be bottoming out. Since June 2006, when this trend started, the value of assets managed by such schemes has practically halved, falling to around €722 million, with the proportion invested in Government securities

[6] As indicated in the Financial Stability Report 2008, this test does not consider other sources of funding available to banks.
[7] The latest available data for the insurance sector were those for March 2009.

peaking at 55%. Likewise, professional investment funds, whose ownership is now evenly split between households and the corporate / non-profit sector, contracted for the fifth consecutive quarter, shrinking by another €14 million to under €100 million.

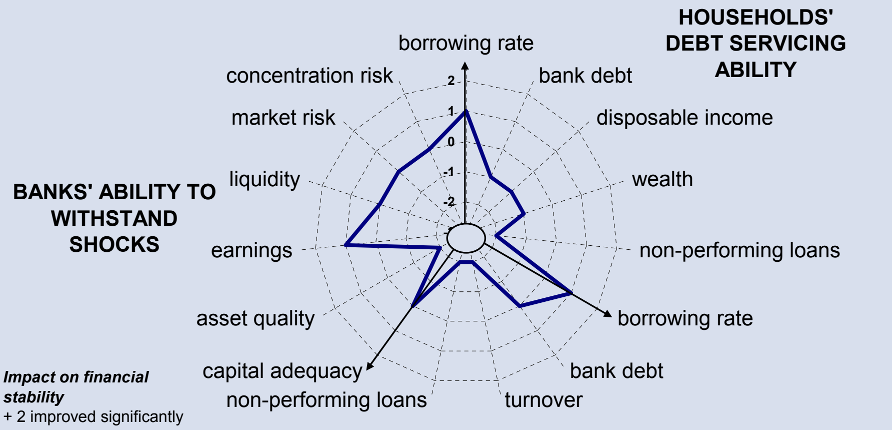
Updated risk outlook

Although market sentiment has improved in the last few months, the Maltese financial system remains vulnerable. The risks identified in the Financial Stability Report 2008 have not disappeared, and some, indeed, have started to materialise. Chart 5 shows a qualitative summary assessment of the changes in financial stability risk factors since December 2008 – apart from those that are of main concern to the Bank, such as the high level of concentration, inadequate provisioning and relatively small capital buffers. The aggregate data mask spots of weakness in specific systemically important institutions, particularly with regard to the level of loan loss provisioning and liquidity positions. Given Malta's small size and the high concentration in its financial sector, a problem in a single institution could easily affect others, and thus warrants close attention on a micro basis.

Looking ahead, weaker global economic conditions would result in further downside pressure on domestic economic activity. This could exacerbate credit risk further, with additional stress likely to hit the banks' credit portfolio as the value of non-performing loans rises further from already high levels. However, at this juncture, and in spite of tighter credit conditions, there do not seem to be any signs of adverse feedback loops from credit institutions to the economy. To a certain extent, the current low interest rate environment is probably mitigating the financial difficulties facing the household and corporate sectors. Problems may arise when interest rates eventually revert to more normal levels, as the exceptional accommodative measures currently being implemented by the major central banks are rolled back.

On the other hand, improved market sentiment and changes to accounting rules have resulted in valuation gains, reversing the negative return on equity registered during 2008. In turn, conservative dividend policies should help strengthen the banks' capital buffers, enabling them to withstand the full range of risks and to build their capital up to more acceptable levels. Banks may, however, still experience a squeezing of net interest income as a result of increased competition, though they

Chart 5
QUALITATIVE ASSESSMENT OF CHANGES IN RISKS TO FINANCIAL STABILITY



Impact on financial stability
+ 2 improved significantly
+ 1 improved slightly
0 practically unchanged
- 1 deteriorated slightly
- 2 deteriorated significantly

appear to be compensating for this by widening their margins in specific business areas where market conditions permit.

In the meantime, the liquidity position of Maltese banks remains good. Funding from deposits has been resilient, though the banks may be susceptible to increasing competitive challenges as the international financial structure changes. In turn, adoption of tighter credit standards is likely to strengthen the long term quality of the banks' loan book.

The Financial Stability Report 2008 had concluded that financial stability conditions in Malta had become more uncertain. Although the degree of uncertainty may have diminished somewhat since the Report was written, risks persist as the financial system remains vulnerable to setbacks arising primarily from the real economy. From a systemic perspective, therefore, it is imperative that banks continue to strengthen their capital buffers, particularly at a time when funding conditions appear rather favourable, so as to be in a position to withstand any future adverse shocks.