FINANCIAL STABILITY REPORT UPDATE 2014

This *Update* covers the first six months of 2014 and evaluates developments which may impact the resilience of the domestic financial system since the publication of the *Financial Stability Report 2013*. It also analyses whether any new risks have emerged.[1] The *Update* is prepared by the Financial Stability Department and is subsequently reviewed and endorsed by the Financial Stability Committee of the Central Bank of Malta.

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In the first half of 2014, the international economic environment remained weak, with growth in the euro area remaining subdued. Macro-financial risks were still elevated, on the back of idiosyncratic risks which developed across different economic regions. Against this background, the domestic economy remained resilient, and again outperformed the euro area average. This, in conjunction with a sound financial system, has ensured, and further safeguarded, Malta's financial stability. As at the end of June 2014, the banking system in Malta, in terms of assets, amounted to 647.5% of gross domestic product (GDP), with the size of the core domestic banks equivalent to 212.3% of GDP.[2] The total assets of domestic insurers and domestic investment funds amounted to 34.3% and 15.3% of GDP, respectively. Core domestic banks hold adequate capital levels with strong profitability despite operating in a challenging low interest rate environment and subdued credit growth. Funding and liquidity risks remained low, whereas credit risk remained the main challenge as non-performing loans increased. The non-core and international banks' links with the domestic economy remained limited, with no implications for the local macro-financial environment. Risks from the other segments of the financial sector are deemed to have remained minimal. The measures identified in the *Financial Stability Report 2013*, namely to strengthen further capital buffers and increase loan loss provisioning, are still relevant.

Macro-financial conditions in the euro area improved gradually, although challenges persisted and economic growth was weak and uneven. Despite external challenges, the domestic economy continued to grow, thus supporting financial stability.

During the first half of 2014, the macro-financial environment in the euro area continued to demonstrate signs of gradual, yet muted, improvement. Financial stress indicators, such as the Composite Indicator of Systemic Stress, remained low and stable for the euro area, following a declining trend since 2012.[3] The banks in the euro area continued to clean and strengthen their balance sheets through raising new capital in anticipation of the European Central Bank's (ECB) asset quality review (AQR) and stress test. Meanwhile, sovereign stress indicators, as represented by sovereign credit default swap rates, have also fallen closer to pre-crisis levels, reflecting fiscal consolidation and structural reforms. Similarly, the Eurozone Composite Purchasing Managers' Index (PMI) remained above 50, indicating improving economic conditions.[4] Financial markets in Europe also continued to improve with equity prices increasing further amidst low market volatility.[5]

[1] The cut-off date for information published in this *Update* is 27 August 2014.
[2] GDP for June 2014 is annualised as a four-quarter moving sum.
[3] Source: European Systemic Risk Board (ESRB) Risk Dashboard.
[4] The PMI is a key benchmark indicator for measuring business and economic conditions. It ranges between 0 and 100. A reading of 50 means that the variable is unchanged; a reading over 50 indicates an improvement while anything below 50 suggests a decline.
[5] The DJ Stoxx 600 improved by 4.1% during the first six months of 2014.

At 0.9%, GDP estimates for 2014 continue to point towards positive growth in the euro area, albeit somewhat weaker when compared with the March forecast of 1.2%.[6] Developments remained disparate across Member States. Moreover, inflation estimates for the euro area for 2014 dropped further to 0.6%, with some countries reporting declining prices. The muted outlook has led to further cuts in the ECB's main refinancing rate, reaching 0.05% by end-September 2014. Concurrently, the ECB's overnight deposit facility rate turned negative, to -0.2%, while the marginal lending facility rate was cut to 0.3%. The historically low levels of interest rates increased the search for yield behaviour by investors, raising the prospect of a reassessment of risk premia and an eventual disorderly unwinding of global imbalances. Furthermore, the relatively weak and uneven economic outlook in the euro area continues to weigh on credit quality and banks' profitability.

In June 2014 the ECB announced targeted longer-term refinancing operations (TLRTO), aimed at stimulating bank lending by the euro area non-financial private sector (excluding mortgages), in an attempt to spur economic growth.[7] In the meantime, further steps were taken towards the creation of a banking union. The Single Resolution Mechanism (SRM) was created through an EU Regulation and entered into force in August 2014, while the Single Supervisory Mechanism (SSM) started operating from 4 November 2014.[8]

In the first half of 2014, the Maltese economy outperformed that of the euro area as a whole, with GDP growing by 3.4% in real terms, 0.2 percentage point faster than the corresponding period a year earlier. Domestic demand remained an important contributor to growth during the first half of the year, with higher private and government consumption, as well as stronger gross fixed capital formation. Furthermore, although both exports and imports declined, the latter dropped by more, so net exports contributed positively to GDP growth. This was partly offset by lower inventories.[9]

The performance of specific economic sectors was quite diverse, with manufacturing and construction sectors amongst those sectors which continued to report weak activity, contributing negatively to growth in gross value added. Furthermore, the financial services sector reported lower returns in the first half of 2014. Meanwhile, sectors such as transport & storage, information & communication and accommodation & food services contributed positively to growth in gross value added. The economic sentiment indicator for Malta trended upwards and by the third quarter of 2014 reached levels previously seen in 2008. In 2015 the economy is projected to grow by 2.8% (2014: 3.0%). The unemployment rate is foreseen to remain broadly stable at 5.8% and the inflation rate to reach 1.3%, 0.6 percentage point higher than the 2014 forecast. These generally positive economic prospects continue to create the right environment for the sustained stability of the domestic financial system.

The size of core domestic banks expanded, accompanied by some shifts in the composition of the balance sheet. The loan portfolio, however, remained the predominant asset component, and continued to be fully funded by customer deposits.

In the first half of 2014, the balance sheet of core domestic banks grew by 4.5%, a larger increase than the 2.5% reported for 2013. At €15.8 billion, total assets of core domestic banks amounted to 212.3% of GDP, a rise from 208% at the end of 2013.[10] All core domestic banks reported an expansion in their total assets. During the first six months of the year, these banks submitted noticeable changes in their balance sheet components. The rate cuts announced by the ECB in June 2014 pushed the deposit facility rate into negative territory, inducing core domestic banks to shift their placements with the Central Bank of Malta to other financial institutions. Placements with the Bank decreased by 84.7% (or €867.4 million) to €156.2 million, equivalent to 1.0% of total assets of core domestic banks. This decline was offset by an increase in interbank exposures (i.e. loans, deposits and repos), which rose by almost €848 million (84.3%) to €1.9 billion. Almost

[6] Source: ECB Staff macroeconomic projections for the euro area (March 2014, September 2014).

[7] In its first TLTRO on the 18 September the ECB allotted €82.6 billion to 255 counterparties. In the second TLTRO on the 11 December the ECB allotted €129.8 billion to 306 counterparties. Such take up was, however, lower than market expectations.

[8] The SSM assigned supervisory powers to the ECB over banks in the euro area, as well as in other Member States that opt to be part of the Banking Union. The SRM will, when fully operational, allow bank resolution to be managed effectively through a Single Resolution Board and a Single Resolution Fund, financed by the banking sector.

[9] Inventories also include statistical discrepancy.

[10] GDP for June 2014 is annualised as a four-quarter moving sum.

all placements are held with foreign credit institutions, the majority of which pertain to non-affiliated entities and are from highly-rated EU countries. As a result, the share of interbank exposures rose by 5 percentage points in the first six months of the year, to 11.7% of total assets.

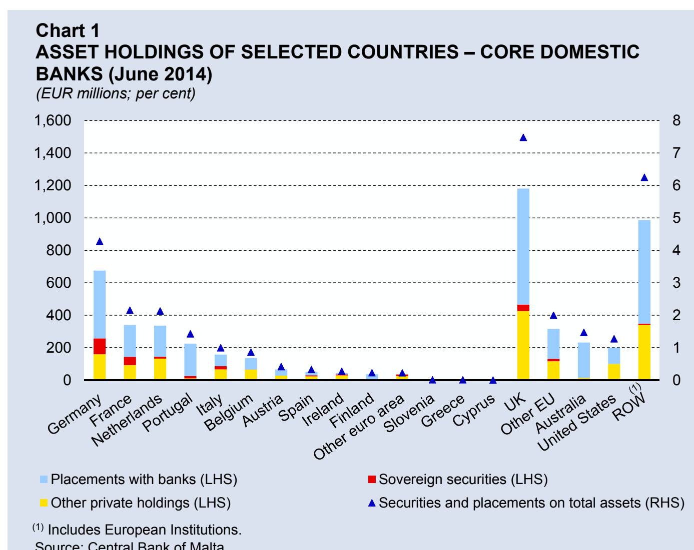
Core domestic banks also reported higher securities' holdings, up by almost €589 million (16.2%) amounting to 26.8% of total assets, almost 3 percentage points higher than in December 2013. This increase was largely represented by investments in foreign securities issued by monetary financial institutions (MFI) and non-financial corporates. Together, these two types of securities accounted for 12.3% of total assets in June 2014, up from 9.9% in December 2013. Holdings of domestic government paper increased by almost 9% in the first half of 2014, representing 12.1% of banks' total assets, up from 11.6% in December 2013.[11]

As a result of the increase in interbank exposures and foreign securities holdings of core domestic banks highlighted earlier, the proportion of foreign asset holdings to total assets reached 31.8% in June 2014, up from 19.4% as at end-2013, reaching €5 billion.[12] From a geographical perspective, such holdings continued to be concentrated in high-rated countries (see Chart 1). Indeed, the reported increase mainly resulted from higher holdings of assets issued in the United Kingdom and Germany, and consisted predominantly of placements with banks and other private sector holdings. Euro area asset holdings amounted to €2.1 billion, up from €1.1 billion in December 2013, reaching 13.3% of total assets. Asset holdings issued in formerly financially-stressed countries also increased, but remained limited to 9.6% of total foreign asset holdings, or 3% of total assets.[13] Meanwhile, exposures to emerging markets remained generally stable at 8% of total foreign asset holdings, or 2.6% of total assets.

The loan portfolio remained the largest asset component for core domestic banks. During the first half of 2014, total loans increased by 1.5%, accounting to 54.7% of total assets, but these were still lower than the 56.3% level as at end-2013. The rise in total lending was mainly driven by mortgage lending, which increased by 4.1%, as consumer credit contracted by 0.8%. Lending to non-bank financial entities also grew, up by 10.7%. Lending to non-financial corporates declined further by 1.1%, mainly driven by a reduction of exposures in the construction sector.

Results from the Central Bank of Malta's Bank Lending Surveys for the first half of the year indicate that credit demand has been picking up. Nevertheless, credit growth remained weak, particularly bank funding to the corporate sector. Indeed, credit standards were still tight in the first six months, possibly somewhat restraining credit growth to particular economic sectors. In this respect, the banks were also being cautious owing to the initiation of the ECB's Comprehensive Assessment consisting of an AQR and a stress test.

Chart 1
ASSET HOLDINGS OF SELECTED COUNTRIES – CORE DOMESTIC BANKS (June 2014)
(EUR millions; per cent)



(1) Includes European Institutions.
Source: Central Bank of Malta.

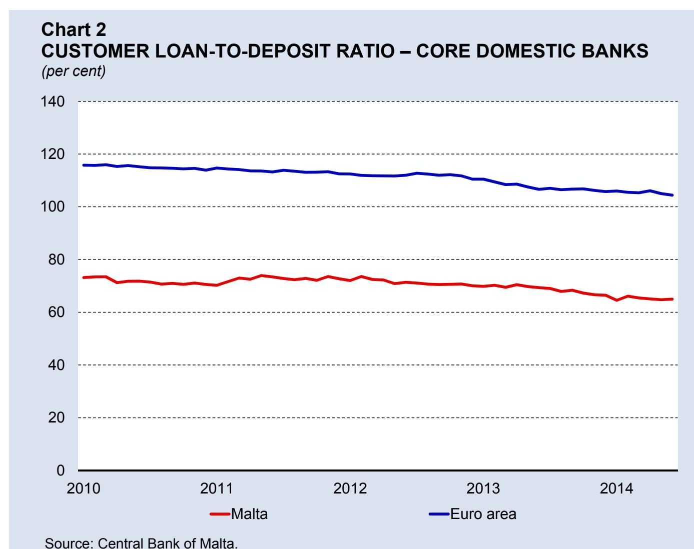
On the liabilities side, customer deposits were once more the main source of funding for core domestic banks, accounting for 84.1% of total liabilities. During the first half of 2014, customer deposits grew

[11] The other securities include foreign sovereign securities, domestic non-financial corporates and domestic MFI securities.

[12] Foreign asset holdings include all securities held by core domestic banks and placements with banks (loans and deposits) which originate from sovereign entities, MFIs and other non-financial private companies outside Malta.

[13] Formerly financially-stressed countries include Cyprus, Greece, Ireland, Italy, Portugal, Slovenia and Spain.

by 3.8%, attributable to both resident and non-resident clients, who increased by 2.5% and 10.6%, respectively. Still, resident customer deposits continued to represent the bulk of deposits, equivalent to 82.6% of total customer deposits. Given the faster growth in customer deposits than loans, the loans-to-deposit ratio dropped by a further 1.5 percentage points to 65%, considerably lower than the average of the euro area (see Chart 2).

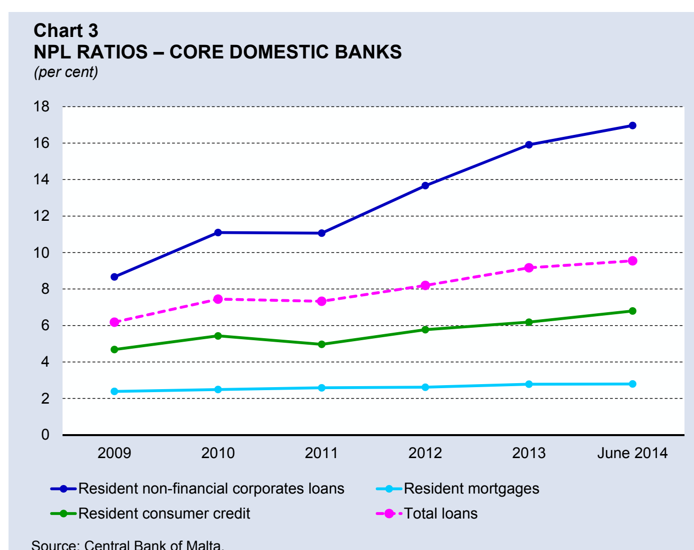


The maturity structure of deposits remained relatively stable, skewed towards short-term funds, that is, those with a maturity of less than one year. Indeed, 59.3% of total deposits relate to savings and current deposit accounts. This proportion increases to 93% if term deposits with a maturity of up to one year are included. Despite their short-term nature, these deposits continue to show stable trends, with little, if any, volatility, particularly with respect to resident customer deposits.

Other sources of funding remained broadly stable and contained; debt securities issued accounted for 1.9% of total liabilities, whereas interbank funding and Eurosystem funding amounted to 0.8% and 0.6% of total liabilities, respectively. The low reliance on wholesale funding reflects the banks' adequate liquidity position as a result of sufficient flows of customer deposits. This is further reinforced by the fact that, as at June 2014, less than one fifth of the collateral pool was utilised for monetary policy operations.

Increase in non-performing loans attenuated by more loan loss provisions

During the first six months of 2014, all but one of the core domestic banks reported an increase in their total non-performing loans (NPL), pushing the aggregate NPL ratio from 9.2% as at end-2013 to 9.5% by mid-2014 (see Chart 3).[14] This was due to a rise in NPLs registered in the corporate sector, up by €35.8 million (5.6%), and – to a lesser extent – to household consumer credit NPLs, which increased by €8.8 million (6.4%).

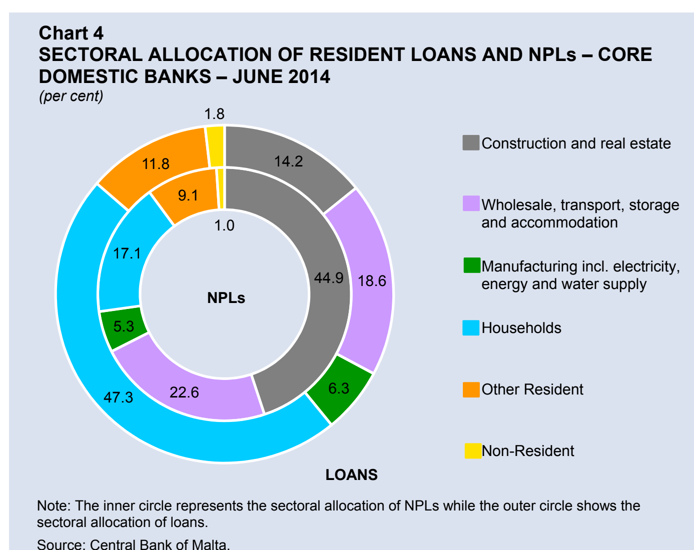


The proportion of non-resident NPLs remained low, amounting to just 1.0% of total NPLs.

[14] NPLs are defined as loans which are doubtful and/or irrecoverable. According to Banking Rule BR/09 doubtful loans are credit facilities whose capital and/or interest are overdue by 90 days and over. Such loans also include facilities which, irrespective of whether the repayment is overdue by 90 days, are considered by banks as giving rise to doubts regarding their recoverability. The NPL ratio is measured as a percentage of total loans.

With respect to the resident loan portfolio, the resident construction and real estate sectors accounted for 14.2% of total loans, slightly lower than the 14.9% recorded at the end of 2013 (see Chart 4). However, these sectors accounted for a proportionally larger share in respect of total NPLs, equivalent to 44.9%.

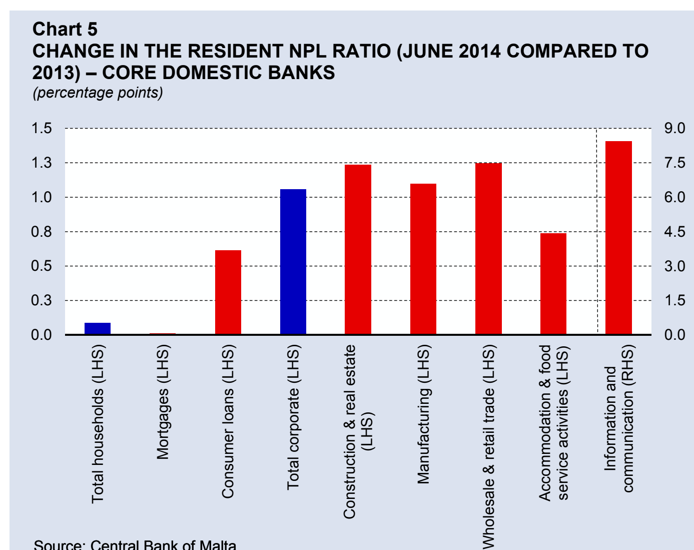
Chart 4
SECTORAL ALLOCATION OF RESIDENT LOANS AND NPLs – CORE DOMESTIC BANKS – JUNE 2014
(per cent)



Note: The inner circle represents the sectoral allocation of NPLs while the outer circle shows the sectoral allocation of loans.
Source: Central Bank of Malta.

Focusing on lending to resident corporate borrowers, the NPL ratio rose by 1.1 percentage points to 17.0% during the first half of the year (see Chart 5). This increase emanated from higher NPLs and from a further contraction in corporate lending (down by 1.1%), with all main economic sectors registering higher NPL ratios. The contribution of the combined construction and real estate sectors was more contained than in previous quarters, contributing to only 7.6% of the increase in corporate NPLs. This increase stemmed entirely from the real estate sub-sector, as NPLs pertaining to the construction sector declined by 2.5%. This contrasts with previous quarters when the construction sector was the main contributor to the increase in NPLs. Meanwhile, the wholesale and retail trade sector was the main driver of the increase in corporate NPLs, contributing almost a third, followed by the information and communication sector, which contributed to around 23% of the overall rise and added an increase of around 8.4 percentage points to the related sectoral NPL ratio.

Chart 5
CHANGE IN THE RESIDENT NPL RATIO (JUNE 2014 COMPARED TO 2013) – CORE DOMESTIC BANKS
(percentage points)

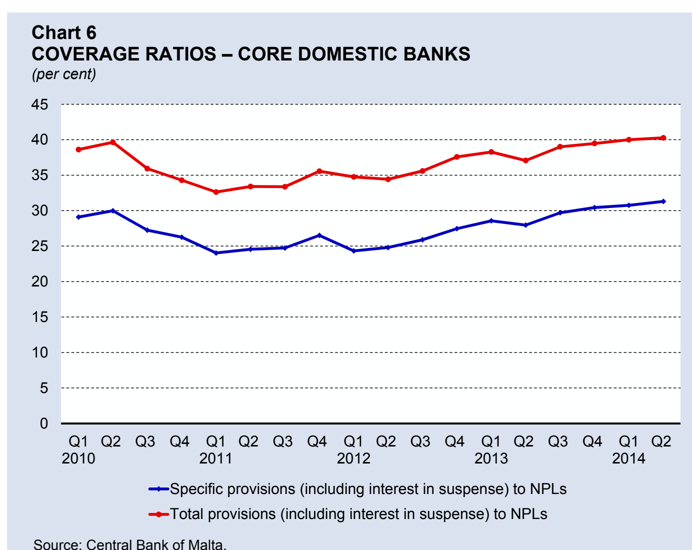


Source: Central Bank of Malta.

On the other hand, while resident household loans accounted for 47.3% of the banks' total loan portfolio, the NPLs of this sector amounted to 17.1% of total NPLs. Indeed, households fare much better than corporates in terms of asset quality. During the first half of 2014, the NPL ratio of resident households increased slightly from 3.4% to 3.5%, attributable to higher non-performing consumer loans and lower consumer lending. The NPL ratio of consumer loans edged up by 0.6 percentage point to 6.8%, while the ratio for mortgages remained stable at 2.8%, as credit for house purchases increased. The low risks from the household sector are sustained by a number of positive developments, including further accumulation of net financial wealth, the prevailing level of interest rates (standing at 3.7% for mortgages and 5.6% for consumer credit) and strong employment growth underpinned by robust economic growth.[15]

[15] Interest rates refer to the weighted average interest rates and are calculated by the Central Bank of Malta.

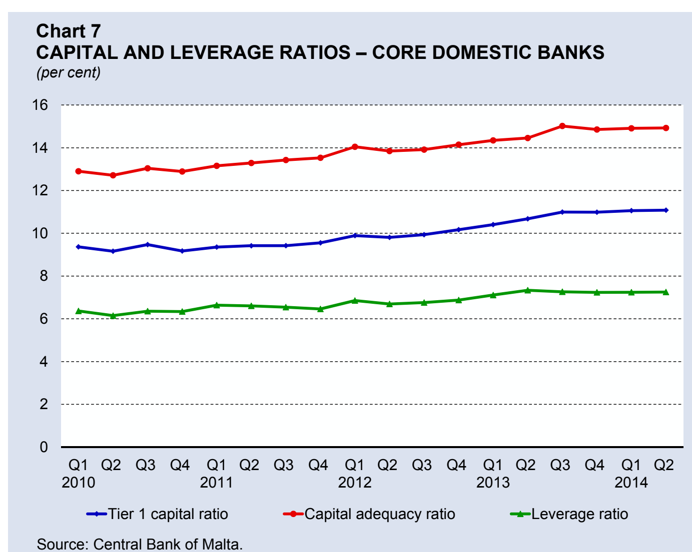
In response to the increase in NPLs, almost all banks raised their provisions both through collective (up by 4.7%), as well as specific provisioning (up by 9.1%). Interest in suspense also increased, up by 8.5%. The coverage ratio thus went up from 39.5% at the end of 2013 to 40.3% at the end of June (see Chart 6).[16] Banks continued to apply a conservative valuation on the collateral backing their lending portfolio, which is mainly in the form of real estate. As at June 2014, 62.7% of the total value of NPLs was covered by collateral. Hence, considering total provisions (40.3%) and collateral (62.7%), the value of NPLs is fully covered. The loan-to-value ratios were kept at a prudent level, averaging at 74.4% and 63.5% for residential and commercial property-backed loans, respectively.[17]



Capital and liquidity positions remained adequate, and well above current regulatory requirements.

The first six months of the year were characterised by a healthy liquidity position for core domestic banks. The liquidity ratio (liquid assets as a percentage of short-term liabilities) stood at 42.6% in June 2014, down from 49.0% as at the end of 2013. This, however, remained comfortably above the 30% minimum threshold, varying between 37.3% and 79.2% across banks.[18] The decline resulted from an increase in short-term liabilities and a drop in liquid assets, and reflects the lower usage of the overnight deposit facility at the Central Bank of Malta, following the negative deposit rate. The majority of the banks' liquid assets (67.8%) are in the form of marketable debt securities, whilst the rest consisted mainly of balances held with other credit institutions. Early indications show that banks are restructuring their balance sheets and are expected to meet the new Liquidity Coverage Ratio regulatory requirements.

During the first half of the year, banks also maintained a stable capital position, with a capital adequacy ratio (CAR) of 14.9% and a Tier 1 capital ratio of 11.1%, well above the respective statutory thresholds of 8% and 4%, respectively (see Chart 7).[19]



[16] The coverage ratio is defined as total provisions and interest in suspense to NPLs.
[17] The loan-to-value ratio is based on a sample of the first 50 new loans approved by four out of five core domestic banks.
[18] BR/05/2007 Liquidity Requirements of Credit Institutions authorised under the Banking Act 1994.
[19] The capital ratios are based on Banking Rule 02. Based on the CRR/CRD definitions, which came into force in January 2014, the total capital ratio would stand at 14.1% while the CET1/T1 capital ratio would stand at 11.2%. These ratios are not comparable with ratios presented in previous *Financial Stability Reports*.

Despite wide variations across the five core domestic banks, the banks' capital positions appear to position them in compliance with the new CRD IV/CRR framework, which demands stricter requirements for the quality and quantity of capital. The leverage ratio, measured as capital and reserves to total assets, improved further from 7.2% to 7.3%.

A number of stress-testing exercises were carried out on June 2014 data by the Central Bank of Malta, measuring the resilience of core domestic banks to specific shocks. The tests revealed that the overall loss absorption capacity of these core domestic banks remains robust when compared with December 2013. The univariate stress tests simulated:

i) credit quality deterioration in the securities portfolio;
ii) increase in NPLs due to adverse macroeconomic conditions;
iii) drop in property prices;
iv) persistent deposit withdrawals.

The results for test (i) remained broadly unchanged, whilst in the application of tests (ii) and (iii) a minor deterioration in the core capital adequacy ratio (CCAR) of the banking system is registered due to a decrease in the collateral coverage ratio. In these tests, provisions were increased to compensate for the assumed rise in NPLs. The CCAR however remains comfortably above the required regulatory requirements. In the assessment of persistent deposit withdrawals (test iv), the test reveals a marginally weaker overall liquidity position of the domestic financial system owing to a higher proportion of demand deposits.

On 26 October the ECB published the results of an independent bottom-up stress test carried out as part of a wider comprehensive assessment.[20] The box below presents the scope, main findings and conclusions of the comprehensive assessment (CA), followed by an overview of results of domestic banks.

BOX 1: ECB COMPREHENSIVE ASSESSMENT

The CA formed part of the preparatory work for the establishment of the SSM. The first part of the assessment consisted of an AQR, which checked the accounting models, policies and practices of 130 European banks that account for more than 80% (€22 trillion) of total assets in the euro area banking system. The AQR was followed by a bottom-up stress test in which the resilience to baseline and adverse shocks was assessed by the banks themselves, subject to a quality assurance process by the ECB. The more benign baseline scenario was mainly based on the 2014 winter forecasts of the European Commission, which was extended using a model based approach to cover the period to 2016. The adverse scenario reflected the threats to the European financial system prevailing in spring 2014. These include an increase in global bond yields, deterioration in credit quality, the re-emergence of a sovereign crisis and a rise in the cost of funding. The interconnectedness of participating banks and the second-round effects arising from the macro-financial linkages were not accounted for in the framework.

Both the AQR and stress test made use of a common methodology and harmonised definitions. The AQR and stress test were subject to a rigorous quality assurance process by banks, national supervisors and the ECB. When gaps, such as those in generic provisioning or in loan classification, were identified in the AQR phase, prudential measures were taken and loaded into the 2013 starting point of the stress test.

[20] https://www.bankingsupervision.europa.eu

The AQR identified a €136 billion (18%) increase in NPLs. With respect to the stress test, the results show that most of the banks in Europe would be resilient to the shocks contemplated in both baseline and adverse scenarios, even after adding the impact of the AQR. The CET1 capital of the participating banks would deteriorate by €216 billion, of which €34 billion represent AQR-related adjustments. The minimum capital requirements increased by a further €47 billion as a result of increased risk-weighted assets.

Of the 130 banks in scope for CA, 25 banks failed the test, with a total capital shortfall amounting to €24.6 billion. Of the 25 failing banks, between January and September 2014, 12 banks raised capital while the remaining 13 banks, with a combined capital shortfall of €9.5 billion, are implementing capital plans to reinforce their capital within nine months from the end of the assessment.

In the local context, Bank of Valletta plc (BOV), HSBC Bank Malta plc (HSBC) and Deutsche Bank (Malta) Ltd (Deutsche) were included in the sample of the CA. The CET1 ratios of the three banks remained above the baseline and adverse thresholds, which were set at 8% and 5.5%, respectively.

In terms of bank profitability, the net income of BOV stood at €55 million in 2013 after AQR adjustment. In the baseline scenario of the stress test, net income remained positive supported by stable net interest income and operating profits. In the adverse scenario the profitability of the bank turned negative. As a result, in terms of capital, the total comprehensive assessment worst impact for BOV stood at +0.7 percentage point in the baseline scenario and -2.3 percentage points in the adverse scenario, pushing the CET1 ratio of the bank in the latter scenario down from 11.2% to 8.9%. The latter, however, remained well above the established threshold of 5.5%. Of the total comprehensive assessment impact of -2.3 percentage points, -0.5 percentage point was due to the AQR.

The 2013 net interest income of HSBC ex post AQR adjustment stood at €38 million. HSBC ended both baseline and adverse scenarios with positive profitability that was sustained by high net interest income and operating profits. The worst impact of the comprehensive assessment on the balance sheet of HSBC was -0.7 percentage point in the baseline scenario and -1.0 percentage point in the adverse scenario, with the CET1 ratio going down from 9.9% to a minimum of 8.9%. The latter also remained well above the established threshold of 5.5%. Of the total comprehensive assessment impact of -1.0 percentage point, -0.9 percentage point was due to the AQR.

The AQR impact emanating from prudential adjustments in collective provisioning and increase in specific provisioning following the credit file review stood at €16 million for BOV and €30 million for HSBC. However, the accounting impact of these prudential measures depends on the outcome of future discussions to be held between the banks and the SSM.

The CET1 ratio of Deutsche Bank remained broadly unchanged in the baseline scenario, declining by a marginal 0.8 percentage point from its initial 281.4%. In the adverse scenario, the CET1 ratio of the bank shed 142.6 percentage points, declining from 281.4% to 138.8%. Deutsche Bank does not hold a loan portfolio and thus there is no impact from the AQR.

Table 1
MAIN COMPONENTS OF THE PROFIT AND LOSS ACCOUNT
EUR millions

			2013		2014
	2012	2013	Jan. - June	July - Dec.	Jan. - June
Total net-interest income	**328,679**	**306,332**	**154,843**	**151,489**	**145,394**
Net interest income on intermediation	237,601	231,948	118,733	113,216	109,810
Other net-interest income	91,078	74,383	36,111	38,273	35,583
Non-interest income	**163,328**	**164,041**	**102,490**	**61,552**	**77,397**
Trading profits[1]	21,573	15,301	21,488	(6,188)	3,943
Other non-interest income	141,755	148,741	81,002	67,739	73,454
Non-interest expense	**(258,481)**	**(257,082)**	**(125,441)**	**(131,641)**	**(132,000)**
Net profit before tax	**213,555**	**213,291**	**131,892**	**81,399**	**90,790**

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

The profitability of core domestic banks remains healthy, despite lower reported earnings resulting from lower non-interest income and net-interest income, as well as higher non-interest expenses.

Aggregate profits before tax reported by core domestic banks during the first six months of the year amounted to €90.8 million, lower when compared with the same period a year earlier (see Table 1). This drop mainly reflected lower non-interest income, predominantly due to reduced trading profits from valuation movements. Dividend income also dropped, although by a lesser extent. Banks also reported lower net interest income, primarily from intermediation activities, as interest income declined at a faster pace than interest expenses. Furthermore, non-interest expense increased, further weakening profits. These developments led to a drop in profitability ratios, with the return on equity (ROE) and return on assets (ROA) standing at 15.6% and 1.1% respectively, in June 2014, down from 19.9% and 1.4% as at December 2013. These ratios, however, are still somewhat higher when compared with the euro area average of 3.6% and 0.2%, respectively.

The other components of the domestic financial system continue to pose limited financial stability risks.

The other components of the domestic financial system are defined as non-core domestic and international banks, insurance companies and investment funds. These sectors' performance stayed favourable, with their capital and liquidity levels remaining adequate during the first half of the year. The level of financial stability risks posed by these institutions is deemed to have remained low.

The size of the **non-core domestic banks** increased by 0.2% during the first half of 2014, and is equivalent to 71.4% of GDP, down from 73.0% in 2013.[21] Although rising by 6.3% during the first half of the year, the level of their loans to residents remained low, forming only 2.3% of the total resident lending portfolio as at the end of June 2014. These banks further increased their holdings of domestic government paper by 29.5%, however still accounting for less than 5% of total outstanding government debt. This reaffirms the limited links of these banks to the domestic economy and the consequent small and contained risk to financial stability.

Non-core domestic banks continued to fund their operations primarily from wholesale sources, accounting for 48.7% of total liabilities in June 2014, up from 44.2% as at the end of 2013.[22] Wholesale funding mainly originated from related credit institutions. In contrast, customer deposits, which increased by 6.5% in the first half of the year, financed another 31.3% of these banks' balance sheets. Slightly more than half of these deposits originated from residents. However, despite increasing by 9.7% during the first half of the year,

[21] Structurally, during the first months of 2014, Mediterranean Bank p.l.c. started procedures to take over Volksbank Malta Limited. The takeover was effected on 25 September 2014.

[22] Wholesale funding is defined as deposits, loans, repos and debt securities with related and other credit institutions, as well as repos held with non-bank sectors.

resident customer deposits of non-core domestic banks continued to account for a low proportion of total resident customer deposits held by the Maltese banking system, equivalent to 7.5%. The reliance of these banks on Eurosystem funding and debt securities issued remained below 1% of their liabilities for each funding source. No new debt securities were issued during the first half of the year.[23]

The capital levels of non-core domestic banks (predominantly in the form of Tier 1 capital) remained adequate during the first half of the year, albeit the CAR dropped from 24.6% to 18.7%, spurred mainly by a drop in Tier 1 capital. This reduction was the result of corporate actions by two banks in connection with their group activities. Higher risk-weighted assets also contributed to the drop in the CAR. As a result of the fall in capital, the leverage ratio, while remaining healthy, decreased from 20.0% to 10.4%. The liquidity position of non-core domestic banks improved further, as the liquidity ratio increased to 104.0% in June 2014, from 95.9% as at the end of 2013.

Pre-tax profits for the first half of 2014 declined by 78.6% (€26.5 million) when compared with the same period a year earlier. The decline in profits was driven by one bank, which reported higher impairment charges. As a result of lower profits, the ROA declined by 0.5 percentage point when compared with levels reported for 2013 to 0.5% by June 2014.

During the first half of the year, the number of banks classified as **international banks** remained 13.[24] Nevertheless, total assets contracted by 8.9% during the period under review, amounting to 363.8% of GDP in June 2014, down from 409.0% as at the end of 2013. The drop reflected the downsizing of several banks, which are consolidating their position at group level, leading to lower intragroup loans and deposits. The groups' resident lending levels remained insignificant.

International banks continued to fund their balance sheets mainly from wholesale funding, primarily from unrelated credit institutions. Such funding reached over 70% of total liabilities in June 2014, up from 59.6% as at the end of 2013. Customer deposits financed another 18.2% of the banks' balance sheet, whereas Eurosystem funding remained marginal, equivalent to a mere 0.3% of total liabilities.

Further to the voluntary consolidation of group operations of a number of international banks, total own funds contracted by 58.8% in the first half of 2014. Although remaining healthy and well above the 8% threshold, the CAR fell to 54.3%, from 119.6% in 2013. Almost all capital remained in the form of Tier 1 capital. Similarly, the leverage ratio also dropped from 75.2% in 2013 to 50.1% in June 2104. Owing to this retrenchment, liquid assets also declined, causing the liquidity ratio to drop from 204.2% to 43.0% during the first half of the year, which remains well above the regulatory minimum of 30%.[25] Profits for this category of banks contracted by 8.3% when compared with the corresponding period a year earlier, with the fall mainly emanating from the downsizing of operations on the part of a number of banks. The drop in profits emanated from higher losses in the non-interest component, which was partly offset by higher net interest income. At the end of June 2014, the ROE stood at 2.5%, down from 2.6% as at end-2013, whilst the ROA remained unchanged at 0.8%.

The performance of the **insurance sector** remained favourable during the first half of the year, with profits for the total sector increasing by 4.6%. This improvement was wholly registered by the non-life sector, which profits increased by 26.2%. Underwriting business for this sector was rather positive during the year, with net premia written expanding by 27.4%.[26,27] On the other hand, investment income fell by 0.7%. On the expenditure side, net claims paid rose by 7.7%, also impacted by a new company which started operating in early 2013. The sustainable underwriting activity is evidenced by the combined ratio, which remained over 90%.[28]

[23] This maintained their outstanding bonds at €45.4 million or 4.6% of all corporate bonds (including bank securities) listed on the Malta Stock Exchange.

[24] During the first half of the year, Pilatus Bank Limited started operating; however, it only forms 0.1% of the international banks' total assets. Moreover, Erste' Bank (Malta) Limited ceased operations in Malta during the same period under review.

[25] Branches are excluded from solvency and liquidity calculations.

[26] Net premia written refer to premia written net of reinsurance.

[27] The increase in the premia of the non-life sector is overstated due to a change in the reporting methodology of one insurance company. Removing this inconsistency, net premia for the non-life sector is estimated to have increased by around 9.3%.

[28] The combined ratio is defined as the sum of net claims incurred and the net operating expenses over the net earned premia. A combined ratio of less than 100% signals underwriting profit, as insurers are taking in more in premia than paying out in claims and other expenses. The ratio for June 2014 is based on a four-quarter moving sum.

The life sector reported lower profits, down by 5.8%, despite the generally positive underwriting performance and higher investment income. Lower profits resulted from higher technical reserves carried forward to the second half of 2014 as compared with those brought forward from 2013. Otherwise, investment income reported by life insurance companies was positive and was the largest contributor to profits. In the first six months of 2014, investment income rose by 42.0% compared with the same period a year earlier, mainly arising from unrealised capital gains owing to consistently falling yields on bonds. Net premia written also increased, up by 7.6%, and were largely influenced by single premium business.[29] Net claims paid by the life sector dropped by 2.7% as a result of lower death, maturity and surrender claims.

The balance sheet of the insurance sector expanded by 5.2% during the first half of 2014, driven predominantly by the life and, to a lesser extent, the non-life sector.[30] The asset structure remained broadly stable, with holdings of domestic government bonds forming almost a third of the total investment portfolio, and exposures to emerging economies and vulnerable countries remaining very limited. The capital-to-assets position of the insurance sector remained relatively stable at 15.1% in June 2014 (life: 11.1% and non-life: 41.7%), whereas the sector's reserves earmarked to cover future claims (technical reserves) increased by 5.7%. The risk retention ratios remained largely stable during the first six months of the year, with that for the life sector reaching 95.6% and that for the non-life sector standing at 77.1% in June 2014.[31] The ratio for the whole sector stood at 87.8%.

With respect to the **investment funds sector**, total assets expanded by 35.0% during the first half of the year, mainly on behalf of Collective Investment Schemes (CIS), which grew by 39.9%. This was largely driven by a number of new sub-funds, which started operating in 2014. Total assets of Professional Investor Funds (PIF) increased by 9.9%.[32] Almost half of CIS' investment assets remained in domestic government bonds, whilst PIFs continued to invest principally in domestic and foreign equities, which stood at 70.3% and 27.3% of investment assets, respectively, at the end of June.[33] The net asset value of the investment funds sector increased by 35.2%, reflecting both structural developments in CIS and a 6% increase in pre-tax profits by the aggregate investment funds sector under analysis.

Risk Outlook

In the short term, the outlook for the domestic financial system remains benign, supported by the system's adequate capital buffers, ample liquidity and strong profitability. The domestic economy continued to be supportive of financial stability, despite challenges posed by subdued economic conditions in the euro area (see Table 2).

The pick-up in economic activity in Malta, coupled with improved government finances, has attenuated somewhat the bank-sovereign nexus. Such vulnerability is expected to remain stable at a moderate level. From an international perspective, the impact of vulnerabilities emanating from the re-emergence of the sovereign debt crisis is expected to remain low, despite concerns about the sustainability of sovereign debt in some countries.

The narrow domestic economic base gave rise to an elevated degree of concentration in the banks' lending portfolio, particularly towards construction and real estate. Although this vulnerability is structural in nature, banks are reducing such exposures, and hence the outlook is expected to remain stable when compared with 2013.

[29] Single premium business refers to policies paid through a single premium payment at the beginning of the term, rather than premia paid over a longer period of time.

[30] The latter was boosted by growth in a company which started operating locally in 2013 and by the change in the reporting methodology of another company. Growth was however registered by all domestic insurance companies.

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

[32] The investment funds considered to be relevant for financial stability purposes, and which are thus analysed in this report, are those funds carrying most of their business with residents and whose total assets exceed €5.5 million. Whilst the number of PIF included in this analysis remained stable over the first half of the year (six schemes and seven sub-funds), CIS schemes dropped by one to nine, as one scheme closed down, with its sub-funds transferred to another scheme. In the process, sub-funds of the latter scheme were also increased, bringing the total number of CIS sub-funds from 29 to 31.

[33] Only 1.7% of professional investor funds' investment assets were in the form of domestic government securities as at June 2014.

With regard to the vulnerabilities emanating from within the financial sector, the upward trend in NPLs continues to be a key challenge, partly driven by the weak performance of some economic sectors which rely substantially on bank credit. This, together with the external economic environment, particularly the prolonged period of low interest rates, will continue to exert downward pressures on bank profitability. Despite the high reliance on short-term funding, roll over risks for core domestic banks are deemed to be minimal, given their historical stable nature.

The Comprehensive Assessment that was run on 130 European banks concluded that the three participating local banks' capital ratios remained healthy and above the established thresholds following the AQR and stress test. The AQR impact resulted from increased generic provisioning and additional specific provisions following a credit file review. It should be noted that since the AQR exercise is prudential in nature, its accounting implications still need to be analysed further during discussions to be held between the regulator and the banks, also taking into consideration accounting standards.

Overall, the banks need to remain vigilant and thus continue to use prudent credit risk mitigation practices, particularly in respect of loan loss provisions and limitation of loan forbearance. The revised Malta Financial Services Authority Banking Rule 09 also provides correct guidelines on credit risk governance practices, ensuring better harmonisation across the whole banking sector. Furthermore, in view of more stringent CRR/ CRD IV rules, banks are encouraged to continue strengthening their capital buffers, possibly through more prudent dividend pay-out policies. This is particularly relevant in view of the downward pressures on profits on the back of low interest rates and slow credit growth. Looking ahead, external pressures, particularly those arising from weak euro area economic growth, low inflationary pressures and a prolonged low interest rate environment, may be expected to exert a marginally higher negative impact.

Table 2
SUMMARY OF RISKS

Main vulnerabilities and risks for the financial system	Type of risk	Change in risk level since 2013 FSR	Risk position as at H1 2014			Risk outlook for H2 2014 with respect to H1 2014
			Moderate	Medium	Elevated	
Vulnerabilities within the financial system						
Increasing non-performing loans stemming from sectoral activity	Credit	↑			●	↑
Challenging conditions for profitability	Profitability	↑		●		↔
High proportion of short-term funding	Liquidity	↔	●			↔
Vulnerabilities outside the financial system						
Concentration of bank lending owing to a narrow economic base	Credit	↔		●		↔
Domestic macroeconomic developments	Credit, Profitability	↓		●		↓
Exposures of the financial sector to the Maltese Government	Profitability	↔	●			↔
Subdued economic conditions in the euro area	Credit, Profitability	↑			●	↑
EU sovereign debt crisis	Contagion, Profitability	↓	●			↔

APPENDIX

Appendix: Financial Soundness Indicators

	Core Banks				Non-Core Banks*				International				Total Banks			
	2011	2012	2013	Jun-14	2011	2012	2013	Jun-14	2011	2012	2013	Jun-14	2011	2012	2013	Jun-14
Core FSIs																
Regulatory capital to risk weighted assets	13.53	14.14	14.87	14.93	29.36	29.02	24.59	18.75	115.53	115.73	119.60	54.26	56.78	55.82	46.20	25.78
Regulatory Tier 1 capital to risk-weighted assets	9.55	10.17	11.00	11.08	27.63	25.89	23.31	17.39	114.37	115.19	119.59	54.25	54.22	53.30	43.88	23.38
Non-performing loans net of specific provisions to total own funds (capital)	54.45	57.03	59.44	60.36	9.50	7.33	11.38	18.72	0.08	0.17	0.79	1.78	6.80	7.49	11.96	22.98
Non-performing loans to total gross loans	7.33	8.20	9.16	9.55	4.47	4.07	4.75	5.37	0.45	0.50	1.16	1.31	3.25	3.78	5.55	6.52
Sectoral distribution of resident loans to total loans																
Agriculture	0.30	0.29	0.30	0.28	0.07	0.07	0.06	0.05	0.00	0.00	0.00	0.00	0.11	0.12	0.16	0.17
Fishing	0.12	0.12	0.14	0.10	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.04	0.05	0.07	0.05
Mining and quarrying	0.08	0.08	0.05	0.05	0.01	0.01	0.01	0.01	0.00	0.00	0.00	0.00	0.03	0.03	0.03	0.03
Manufacturing	3.30	3.86	3.42	3.31	0.34	0.36	0.35	0.30	0.00	0.00	0.00	0.00	1.21	1.41	1.75	1.91
Electricity, gas, steam and air conditioning supply	5.70	2.50	2.37	2.25	0.10	0.11	1.39	2.38	0.00	0.00	0.00	0.00	2.06	0.97	1.34	1.60
Water supply; sewerage waste management and remediation activities	0.76	0.79	0.77	0.73	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.27	0.30	0.38	0.41
Construction	12.09	11.17	10.43	9.83	4.57	4.17	0.41	0.32	0.00	0.00	0.00	0.00	4.72	4.67	5.25	5.60
Wholesale and retail trade; repair of motor vehicles and motor cycles	9.91	9.40	9.06	8.97	1.22	1.79	0.62	0.60	0.00	0.00	0.00	0.00	3.67	3.79	4.59	5.15
Transportation and storage	4.63	4.36	4.07	4.38	1.08	0.95	0.80	0.66	0.05	0.00	0.00	0.00	1.78	1.77	2.12	2.57
Accomodation and food service activities	5.50	5.50	5.41	5.27	0.10	0.12	0.10	0.13	0.00	0.00	0.00	0.00	1.99	2.14	2.72	3.00
Information and communication	1.37	1.33	1.35	1.15	0.06	0.09	0.07	0.10	0.00	0.00	0.00	0.00	0.50	0.52	0.68	0.66
Financial and insurance activities	2.12	5.00	4.58	4.89	0.39	0.23	0.60	0.22	0.00	0.00	0.03	0.02	0.80	1.96	2.36	2.80
Real estate activities [includes inputed rents of owner-occupied dwellings]	4.05	4.03	4.48	4.36	3.13	3.04	3.95	3.53	0.00	0.00	0.00	0.00	1.71	1.93	2.67	2.95
Professional, scientific and technical activities	1.05	0.69	0.51	0.49	0.06	0.04	0.04	0.03	0.00	0.00	0.00	0.00	0.38	0.27	0.26	0.28
Administrative and support service activities	1.13	1.08	1.03	1.02	0.52	0.51	0.51	0.45	0.01	0.01	0.01	0.01	0.45	0.46	0.57	0.64
Public administration and defence; compulsory social security	1.47	1.49	1.60	1.65	0.00	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.53	0.58	0.80	0.93
Education	0.41	0.43	0.41	0.40	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.15	0.17	0.21	0.22
Human health and social work activities	0.54	0.64	0.66	0.66	0.28	0.27	0.25	0.22	0.00	0.00	0.00	0.00	0.22	0.27	0.36	0.40
Arts, entertainment and recreation	0.51	0.73	0.75	0.73	0.36	0.32	0.24	0.20	0.00	0.00	0.00	0.00	0.21	0.31	0.40	0.44
Other services activities	0.36	0.38	0.41	0.37	0.03	0.03	0.03	0.02	0.00	0.00	0.00	0.00	0.13	0.15	0.21	0.21
Households and individuals (excl. sole proprietors)	42.95	44.38	46.39	47.27	0.75	0.81	0.70	0.53	0.01	0.01	0.01	0.01	15.52	17.23	23.25	26.78
Mortgages	34.60	36.28	38.41	39.47	0.68	0.71	0.57	0.41	0.00	0.00	0.01	0.01	12.51	14.09	19.25	22.36
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	0.00	0.00	0.00	0.00
Non-resident loans	1.65	1.75	1.82	1.85	86.94	87.09	89.85	90.24	99.94	99.98	99.95	99.96	63.51	60.90	49.83	43.20
Return on assets	*1.32*	*1.63*	*1.44*	*1.13*	0.49	1.40	0.95	0.46	1.20	1.26	0.79	0.82	1.16	1.37	0.99	0.88
Return on equity	*19.46*	*23.90*	*19.91*	*15.58*	*1.37*	*6.39*	*5.78*	*6.14*	*3.90*	*3.63*	*2.62*	*2.46*	*5.09*	*5.90*	*4.99*	*4.93*
Interest margin to gross income	*72.46*	*66.80*	*65.13*	*68.12*	*69.96*	*28.98*	*56.02*	*60.92*	*89.00*	*124.43*	*178.01*	*199.68*	*79.11*	*83.14*	*101.18*	*111.53*
Non-interest expenses to gross income	*54.07*	*45.54*	*48.08*	*53.76*	*45.53*	*28.69*	*44.28*	*45.29*	*8.87*	*7.06*	*10.06*	*13.04*	*34.10*	*27.44*	*34.92*	*38.61*
Non-interest income to gross income	*27.54*	*33.20*	*34.87*	*31.88*	*30.04*	*71.02*	*43.98*	*39.08*	*11.00*	*-24.43*	*-78.01*	*-99.68*	*20.89*	*16.86*	*-1.18*	*-11.53*
Liquid assets to total assets	24.09	28.81	29.48	26.20	14.88	14.40	16.63	19.35	7.33	9.90	28.14	19.14	16.11	19.64	26.85	23.56
Liquid assets to short-term liabilities	44.10	49.07	48.99	42.56	91.41	82.58	95.87	103.97	108.18	145.98	204.20	43.03	49.59	55.61	59.58	47.33
Other FSIs																
Coverage ratio	35.57	37.59	39.48	40.27	54.35	59.74	41.91	44.47	107.67	95.15	55.11	50.67	43.26	43.64	40.98	41.36
Domestic investment securities to total assets	12.76	11.95	12.10	12.58	2.23	2.87	4.33	5.67	0.00	0.00	0.00	0.02	3.77	3.59	4.10	4.76
Foreign investment securities to total assets	11.46	10.73	11.85	14.01	36.05	38.34	39.29	43.29	31.51	36.49	38.27	52.05	26.37	29.55	30.41	38.61
Unsecured loans to total lending	19.79	19.54	21.83	23.84	39.48	50.73	61.56	62.31	54.24	57.82	60.54	49.88	40.64	42.42	41.33	36.87
Assets to total capital and reserves (**)	15.48	14.54	13.82	13.79	4.19	4.88	5.00	9.61	1.56	1.45	1.33	1.99	3.13	3.14	3.65	6.14
Large exposure to capital	138.48	123.12	133.80	135.11	130.02	111.82	103.98	176.52	10.22	10.78	17.08	43.75	32.22	31.40	45.56	91.04
Gross asset position in financial derivatives to capital	4.89	3.20	2.13	1.83	1.49	0.55	1.32	0.86	0.42	0.54	0.01	0.17	0.99	0.86	0.50	0.80
Gross liability position in financial derivatives to capital	11.56	10.76	5.54	6.46	2.42	2.65	0.75	2.01	0.12	0.07	0.12	0.30	1.55	1.53	1.12	2.52
Personnel expenses to non-interest expenses	*52.44*	*53.92*	*51.05*	*50.53*	*36.24*	*39.64*	*44.34*	*43.83*	*21.24*	*25.19*	*33.19*	*28.74*	*46.50*	*48.45*	*48.09*	*46.78*
Customer deposits to customer loans	137.51	142.71	150.46	153.86	55.70	68.96	89.24	84.36	71.93	76.06	139.20	121.84	99.78	106.59	139.76	135.67
Net open position in equities to capital	17.74	17.36	17.40	16.61	78.73	75.15	79.52	21.79	0.89	0.28	0.02	0.04	7.68	7.65	10.59	8.30
Net open position in foreign exchange to capital	-0.13	0.03	0.56	0.12	-1.80	0.82	-1.54	3.17	0.03	-1.21	-0.30	0.02	-0.10	-0.91	-0.27	3.24
Loan to value:(***)																
Residential	73.48	70.38	71.49	74.37												
Commercial	63.16	63.19	67.30	63.52												

(*) Following the bank reclassification exercise carried out using September 2013 data, FCM Bank has shifted from the International Banks' category to the Non-Core Banks' category.
(**) Expressed as a ratio.
(***) Based on a sample of 4 domestic banks, updated June and December.