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CENTRAL BANK OF MALTA

SEVENTH FINANCIAL STABILITY REPORT

2014

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ABBREVIATIONS

ABS	asset backed securities
AQR	asset quality review
BLS	Bank Lending Survey
BR	Banking Rule
CAR	Capital adequacy ratio
CCAR	Core capital adequacy ratio
CBM	Central Bank of Malta
CET1	common equity Tier 1
CDS	credit default swap
CIS	Collective Investment Scheme
CISS	composite indicator of systemic stress
CRD IV	Capital Requirements Directive IV
CRR	Capital Requirements Regulation
ECB	European Central Bank
ESA	European System of Accounts
ESI	Economic Sentiment Indicator
EU	European Union
FSB	Financial Stability Board
FSR	Financial Stability Report
FVC	Financial vehicle corporations
GDP	gross domestic product
GVA	gross value added
GFCF	gross fixed capital formation
HTM	held-to-maturity
IFRS	International Financial Reporting Standards
LCR	liquidity coverage ratio
LFS	Labour Force Survey
LTV	loan-to-value
MFI	monetary financial institution
MFSA	Malta Financial Services Authority
MGS	Malta Government Stocks
MMF	money market funds
MREL	Minimum requirements for own funds and eligible liabilities
MSE	Malta Stock Exchange
NFC	non-financial corporation
NPL	non-performing loan
NSFR	net stable funding ratio
PIF	Professional Investor Funds
PD	probability of default
PSPP	Public Sector Purchase Programme
ROA	return on assets
ROE	return on equity
RWA	risk-weighted-assets
SDW	Statistical Data Warehouse
SME	small and medium-sized enterprises
SSM	Single Supervisory Mechanism
SRM	systemic risk measure
S&P	Standard and Poor's
TARGET2 (T2)	Trans-European Automated Real-time Gross settlement Express Transfer system
TLTRO	targeted longer-term refinancing operations
ULC	unit labour cost

COUNTRY ABBREVIATIONS

AT	Austria
BE	Belgium
CY	Cyprus
CZ	Czech Republic
DE	Germany
EA 19	Euro area 19 Countries
EE	Estonia
ES	Spain
FI	Finland
GR	Greece
HU	Hungary
IE	Ireland
LT	Lithuania
LU	Luxembourg
LV	Latvia
MT	Malta
NL	Netherlands
SE	Sweden
UK	United Kingdom
US	United States

THE DOMESTIC FINANCIAL SECTOR

Banks*

Core Domestic Banks

APS Bank Limited
Banif Bank (Malta) plc
Bank of Valletta plc
HSBC Bank Malta plc
Lombard Bank Malta plc

Non-Core Domestic Banks

BAWAG Malta Bank Limited
Credit Europe Bank NV
FCM Bank Limited
FIMBank plc
IIG Bank (Malta) Limited
Izola Bank plc
Mediterranean Bank plc
Sparkasse Bank Malta plc
Mediterranean Corporate Bank Limited

International Banks

AgriBank plc
Akbank T.A.S.
CommBank Europe Limited
Deutsche Bank (Malta) Limited
Ferratum Bank Limited
NBG Bank Malta Limited
Nemea Bank Limited
Pilatus Bank Limited
ECCM plc
Turkiye Garanti Bankasi A S
Novum Bank Limited

Investment Funds

Collective Investment Schemes

APS Funds SICAV plc
Calamatta Cuschieri Funds SICAV plc
Global Funds SICAV plc
HSBC Malta Funds SICAV plc
HSBC No-Load Funds SICAV plc
Vilhena Funds SICAV plc

Professional Investor Funds

Amalgamated Investments SICAV plc
EOS Sicav plc
HSBC Malta Funds SICAV plc
Landoverseas Fund SICAV plc
Rascasse Capital SICAV plc

Insurance Companies

Life Insurance Companies

MSV Life plc
HSBC Life Assurance (Malta) Limited
GlobalCapital Life Insurance

Non-Life Insurance Companies

Allcare Insurance Limited
Middlesea Insurance plc
Citadel Insurance plc
Elmo Insurance Limited
GasamMamo Insurance Malta
Atlas Insurance PCC Malta

* This edition of the *Financial Stability Report* is based on the above categorisation of banks. For an update on the classification of banks, refer to Box 3 pp. 40–42.

PREFACE

Financial stability is a necessary ingredient for sustainable economic growth as it reflects the ability of the financial system to efficiently allocate financial resources and facilitate payment services to the real economy. It also signifies the ability to allocate savings into productive investment opportunities and to facilitate the efficient settlement of payments. Financial stability also enables the system to absorb shocks that could otherwise undermine its performance, with adverse repercussions on the economy.

The *Financial Stability Report*, hereinafter referred to as the *Report*, reviews and assesses the macro-financial conditions and developments of the Maltese financial system. It evaluates the resilience of the system and identifies sources of potential systemic risk. It also makes the necessary recommendations to preserve and, when necessary, enhance the resilience of the financial system.

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

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

1. OVERVIEW¹

In 2014 world economic growth maintained the pace of the previous year. In the euro area, economic growth turned positive, although the recovery was muted and uneven across Member States. Financial stability risks remained challenging and elevated in certain countries, which remained affected by the legacy of the financial crisis. Nevertheless, systemic stress indices indicate that risks across the euro area were low and in line with pre-crisis levels.

During late 2014 the Single Supervisory Mechanism went into operation. In anticipation, the European Central Bank (ECB) carried out a Comprehensive Assessment (CA) across 130 significant banks in the euro area, consisting of an Asset Quality Review and a Stress Test. Towards the end of the year, the ECB published the results of the exercises, providing a harmonised measure of financial soundness and enhancing the transparency of the significant banks. Out of the 130 assessed banks, 25 banks failed, with a total capital shortfall amounting to €24.6 billion and an increase in non-performing exposures of €136 billion, or 18%. Prior to the publication of the results, 12 banks had already raised enough capital to cover their identified shortfall, while the remaining 13 banks were in the process of preparing capital plans to strengthen their capital levels for completion within nine months of the end of the assessment.

No capital shortfalls were identified in the three domestically significant Maltese banks that participated in the CA, with capital remaining well above the minimum required, even under the adverse stress scenario.

The euro area's financial system remained characterised by weak credit growth, despite the range of non-standard monetary policy measures taken by the ECB, including the targeted longer-term refinancing operations. During the year, inflation in euro area countries remained low. In the early months of 2015, the euro area faced the further challenge of negative inflation, leading to the launch of the Public Sector Purchase Programme. Additional challenges also emerged as a result of political developments in Greece, which resulted in heightened stress on its banking system.

Financial stability is essential for macroeconomic growth, and the two are mutually reinforcing. The Maltese economy remained among the best performers across the European Union, both in terms of economic growth as well as in job creation. During 2014 the gross domestic product (GDP) in Malta expanded by 3.5% in real terms, up from 2.7% a year earlier, mainly driven by both investment and consumption growth. Meanwhile, the contribution of net exports remained positive, but smaller than in the previous year. In 2014 unemployment reached the lowest level of 5.9% since 2002, whereas compensation of employees continued to increase. The situation in public finances improved as the fiscal deficit was cut to 2.2% of GDP, while public debt declined to 68.0% of GDP.

The total assets of the domestic banking sector expanded by 4.8%, reversing the contraction in 2013. More specifically, the total assets of the core domestic banks grew by 12.5% in 2014, predominantly the result of around 29% increase in securities holdings. This mainly reflected higher holdings of securities issued by foreign monetary financial institutions, up by over 50%. Holdings of domestic government bonds by core domestic banks marginally decreased, representing 10.2% of their total assets at the end of the year.

Core domestic banks also reported a rise in credit demand, with their loan portfolio expanding by 4.5% resulting from higher lending to non-financial corporates and residential mortgages. Furthermore, core domestic banks reported some re-balancing in their assets structure, shifting their placements with the Central Bank of Malta to other unrelated foreign credit institutions in search of more favourable returns, following conventional monetary policy decisions by the ECB during 2014 and prospected unconventional measures for 2015. Some re-balancing was also effected in the securities portfolio, with banks increasing their share in foreign private sector debt. The securities portfolio of core domestic banks remained directed towards low-risk high-quality investments. The structure of the core domestic banks' liabilities were broadly stable, with

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

customer deposits financing almost 85% of their total assets. The maturity profile remained mainly short-term as in previous years, also supported by the flattening of the yield curve offering low return differential for holding long-term assets.

The key vulnerabilities to financial stability identified in 2013 were relevant for 2014. However, some risks were intensified, while others softened. In particular, risks stemming from external macroeconomic conditions deepened on account of the persistent economic weakness in the euro area, as well as owing to a number of geopolitical events occurring during the year.

The very low interest rate environment resulting from the monetary policy response to weak macroeconomic conditions has exerted downward pressure on the profitability of core domestic banks and is expected to persist through 2015. Domestic economic risk eased on the back of the positive macroeconomic performance and low unemployment levels, which sustained household income.

While credit risk remains a key challenge for core domestic banks, the NPL ratio peaked towards mid-year and eased slightly in the second half of 2014. Moreover, banks continued to improve their loan loss provisions. As a result, the coverage ratio increased to 44.1% from 39.6% at the end of the previous year, and improved by a further 1.9 percentage points to 46.0%, when the reserves for general risks stipulated under the revised Banking Rule 09/2013 are taken into consideration. Furthermore, core domestic banks remained prudent in their loan sanctioning, maintaining tight credit standards, particularly for certain sectors.

Core domestic banks continued to hold strong capital buffers to sustain their resilience against potential risks. By the end of 2014, the Capital Adequacy Ratio stood at 14.1%, while the Tier 1 Capital Ratio was 10.5%, both higher than regulatory minima. The ratios declined marginally during the year as a result of an increase in risk-weighted assets that outpaced the growth in total own funds, the latter augmented through retained earnings.

Meanwhile, the profits of core domestic banks remained strong, even if somewhat lower than in the previous year. This resulted from higher non-interest expense, including higher impairment charges applied to legacy loans, which were not adequately provided for in previous years. On average, profitability of these banks remained higher than in EU banks of comparable size.

Core domestic banks continued to operate with abundant liquidity, mainly in the form of stable resident deposits. This is reflected in the customer loan-to-deposit ratio, which, at 61.7% by end-2014, was significantly lower than the euro area average of 103.2%. As in previous years, core domestic banks are expected to fully meet the new liquidity requirements proposed under the new supervisory regime, which will be gradually adopted by 2019.

The operations of the remainder of the Maltese banking sector – the non-core domestic banks and international banks – remained mainly focussed on non-residents and had limited links to the domestic economy. Total assets of non-core domestic banks expanded further, up by almost 16%, whereas those of international banks contracted by 1.0%. One bank reduced its size as a result of its parent group action, more than offsetting the expansion in the balance sheets of the other international banks.

The loss recorded in 2014 by the non-core domestic banking group was a result of higher impairment charges predominantly by one bank. The performance of international banks remained positive, largely influenced by the operations of the two branches of non-EU banks. The latter are considerably larger in size compared with other international banks. Both the non-core and international banks continued to meet the liquidity and capital regulatory thresholds.

Total assets of the insurance sector expanded further, partly resulting from the transfer of an investment portfolio of an insurance company to Malta. This influenced the asset class distribution of the investment portfolio of the whole insurance sector, with the share of holdings of Malta Government Stock declining by

around 10 percentage points in total investment assets, closing 2014 at 19.0%, which were offset by higher holdings of equity and other securities. While the sector remained attractively profitable, increased costs, mainly representing higher commission fees, led to a decline of 7.3% in net profit for the year.

The investment funds sector expanded further during 2014, as new Collective Investment Scheme sub-funds opened. Meanwhile, total assets of Professional Investor Funds (PIF) contracted on account of the full redemption of one sub-fund. PIFs continued to account for a small share of the investment funds sector, equivalent to about 10% in terms of assets.

Potential risks arising from non-core domestic banks, international banks, insurance companies and investment funds remained low.

Looking broadly at the whole financial sector, the resilience to financial stability risks remained robust in 2014, despite some ongoing challenges. Table 1.1 provides a general overview of the summary of risks. Looking ahead, the outlook for financial stability is positive, supported by growth projections for the Maltese economy. Nevertheless, banks are encouraged to reduce their NPL levels. Initiatives being promoted by Government to up-date and refresh insolvency laws will further facilitate this process. Banks are also encouraged to use this period of economic growth and stability to continue to strengthen their capital buffers, and augment their loan loss provisions.

Table 1.1
SUMMARY OF RISKS

Main vulnerabilities and risks for the financial system	Type of risk	Nature of risk	Change in risk level since FSR 2013	Risk position as at 2014			Risk outlook for 2015
				Moderate	Medium	Elevated	
Vulnerabilities within the financial system							
The level of non-performing loans	Credit	Cyclical	↔			●	↔
Concentration of bank lending owing to a narrow economic base	Credit	Structural	↓	●			↔
Subdued credit developments	Profitability	Cyclical	↓		●		↔
High proportion of short-term funding	Liquidity	Structural	↔	●			↔
Interlinkages between banks and the insurance and the investment fund sectors	Contagion	Structural	↔	●			↔
Vulnerabilities outside the financial system							
Domestic macroeconomic developments	Credit, Profitability	Cyclical	↓	●			↓
Activity in specific sectors remains subdued, but signs of recovery are evident	Credit	Cyclical/Structural	↔			●	↓
Exposures of the financial sector to domestic sovereign securities	Profitability	Structural	↓		●		↓
Subdued economic conditions in the euro area	Credit, Profitability	Cyclical	↔			●	↔
Euro area sovereign debt crisis	Contagion, Profitability	Cyclical	↔			●	↔
Higher risk-taking in view of the low interest rate environment	Profitability	Cyclical	↔	●			↔

2. THE MACRO-FINANCIAL ENVIRONMENT

This Chapter describes the main macroeconomic and macro-financial developments, which occurred in 2014 and early 2015, to set the background within which the financial sector in Malta was operating. Section 2.1 covers the international scenario, with special focus on the euro area, while Section 2.2 deals with the domestic economic performance.

Global economic growth continued in 2014 with the euro area becoming a positive, though subdued, contributor to overall growth. The European Commission, monetary authorities and the European Supervisory Authorities engaged in various measures to support the economy and preserve financial stability across the European Union. The financial markets responded positively, with declining yields and lower volatility. Nevertheless, looking ahead, pockets of vulnerabilities remain. In particular, country-specific fiscal and liquidity issues may have contagion implications on the rest of the euro area and the European Union.

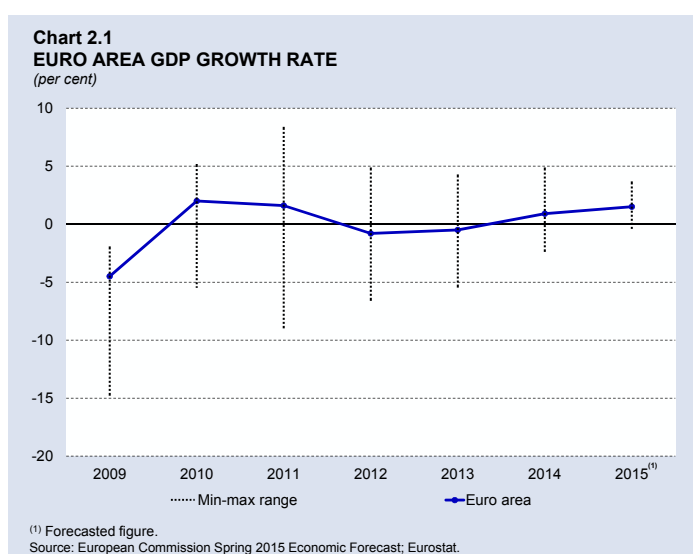
Meanwhile, growth in the Maltese economy improved, underpinned by domestic demand while, at the same time, further consolidation in public finances was observed. Looking ahead, domestic macroeconomic conditions are expected to remain positive and supportive of a sound financial sector.

2.1 The external environment

In 2014 the global economy is estimated to have grown by around 3.4% in real terms, an improvement over 2013 despite a slight slowdown in the last quarter of the year.¹ Global growth is forecast to accelerate in 2015 and 2016, boosted by the positive impact of lower oil prices. Despite the positive outlook, significant downside risks remain, including regional political instability, uncertainty in global financial markets, lower commodity prices and deflationary pressures. On a positive note, the United States and the United Kingdom have recorded higher growth in 2014 compared with 2013 and are expected to grow at a sustained pace in the following quarters.

In 2014 euro area economic growth turned positive, increasing by 0.9% in real terms following two years of contraction. However, the uneven recovery across Member States persisted, with real gross domestic product (GDP) growth varying between -0.5% and 3.6% (see Chart 2.1). Some Member States continued to face a challenging economic environment owing to lower external and domestic demand, as well as a financial system which continued to underperform following the financial crisis. Looking forward, a weaker euro against major currencies may boost competitiveness and improve prospects for the export market.

The improved, yet sluggish external economic scenario, coupled with weak labour markets with little or no increase in wages, remained a key challenge to financial stability in the euro area, apart from emerging geopolitical issues. Risks were particularly high in those Member States still burdened by the legacy of the financial crisis. Although market volatility as captured by VDAX narrowed, compared with the most recent high level observed in 2012, there were periodic bouts of heightened volatility in 2014



¹ European Commission Spring Forecasts, 2015.

(see Chart 2.2). However, during the second half of 2014 the level of uncertainty was partly mitigated by a combination of liquidity provision to stressed banks and further strengthening of prudential supervision in the monetary union. The Single Supervisory Mechanism started operations in November 2014. In the first quarter of 2015, protracted negotiations between Greece and its creditors led to heightened market volatility amid fears of sovereign debt default and the ensuing potential impact on the financial system. However, volatility abated somewhat as default was averted, and a bail-out package was negotiated and approved during August 2015.



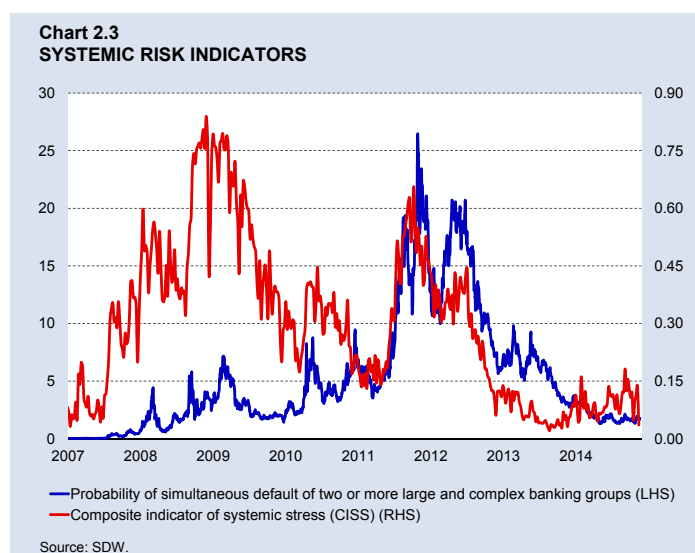
Meanwhile, the euro area labour market remained weak. The unemployment rate slightly eased to 11.6% during 2014, following a peak of 12.0% in 2013. Significant heterogeneity across countries, however, remained. Fiscal consolidation was at the forefront of European efforts to achieve a stable and sustainable economic growth. The fiscal situation improved in a number of countries, with the deficit-to-GDP ratio for the euro area dropping to 2.4% in 2014, even though the gross debt-to-GDP ratio increased to 92.0%.

During the year inflation and related expectations remained low in the euro area. Consequently, the European Central Bank (ECB) took various stimulatory monetary policy actions in line with its mandate to increase the inflation rate close but below 2%. The main refinancing rate was reduced by 10 basis points on two occasions during the year, in June and September, to 0.05%.² The ECB also launched additional non-standard monetary policy measures during the year, including targeted longer-term refinancing operations, an asset backed securities purchase programme and a third covered bond purchase programme to enhance transmission of monetary policy and support the provision of credit to the euro area economy. Despite these efforts, banks remained risk averse and did not supply credit to the extent desired by policy makers. Indeed, financial intermediaries maintained high levels of liquidity and strengthened their capital ratios. The banks' caution in growing their balance sheets was also evident in view of possible capital shortfalls, possibly arising from the Comprehensive Assessment exercise undertaken by the ECB, and in anticipation of the gradual tightening of regulatory requirements. While banks maintained tight, but slightly loosened credit standards, demand for credit remained subdued, reflecting low investment outlays. This instigated the ECB's intent to implement more unconventional measures. As inflation continued to trend downwards in the first quarter of 2015, the ECB's Governing Council announced a Public Sector Purchase Programme, which requires eligible Eurosystem central banks to acquire sovereign bonds and private sector assets for a combined monthly total of €60.0 billion. Malta's monthly contribution to the expanded asset purchase programme is targeted at €36.0 million.

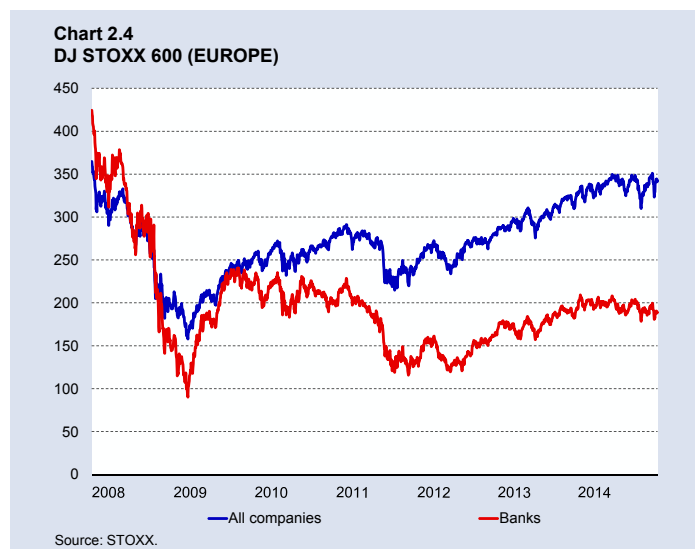
Profitability of banks in the euro area remained subdued. Bank profits have been affected mainly by persistently low interest rates, regulatory and compliance expenses and one-off costs related to legal risks arising from past practices, which in turn limit the banks' ability to build up their capital buffers. The low interest rate environment may have led some banks to search for higher returns, by possibly taking on more risk to improve profitability, leaving them vulnerable to future shocks and amplifying volatility in financial markets. In some parts of the banking system the de-leveraging process has been completed, possibly freeing capital and enabling banks to grant credit.

² The marginal lending facility now stands at 0.3% and the overnight deposit facility at -0.2%.

Despite the uncertain economic and financial environment, the systemic stress index (CISS) for the euro area remained low during 2014, at levels similar to the pre-crisis period (see Chart 2.3). However, towards the end of the year, systemic risk increased slightly as geopolitical tensions and macro-financial issues from specific countries or regions impacted the euro area. Meanwhile, in 2014 the systemic risk measure indicated that the probability of a simultaneous default of two or more large and complex banking groups in the European Union receded.³



The recovery in capital markets was more evident in the beginning of 2014. Several large stock exchanges across the European Union reached new highs. As the uncertainty of possible sovereign default resurfaced, the rally on stock markets ran out of steam in the second half of the year (see Chart 2.4).⁴ Despite this slowdown, funds have been readily available in capital markets as the search for yield intensified in view of low interest rates and low sovereign bond yields. Indeed, the price of risk remained low in most markets and correlation across and within the bond, equity and money markets was similar to pre-crisis levels. Although demand for high yielding assets remained strong for most of



the year, markets reported some outflows from the high-yield bonds, reflecting a subdued outlook for energy companies and emerging markets, as well as countries facing economic difficulties. Market volatility also rose, possibly reflecting heightened probabilities of negative events.⁵

The market for non-bank financial intermediation in the European Union continued to pick up, with indications that this sector has become more concentrated as the largest global asset managers accounted for an increasing share of assets under management. According to the ECB, there is increasing interest in financial stability concerns in this sector within the euro area as current risk policies are somewhat limited in scope.⁶

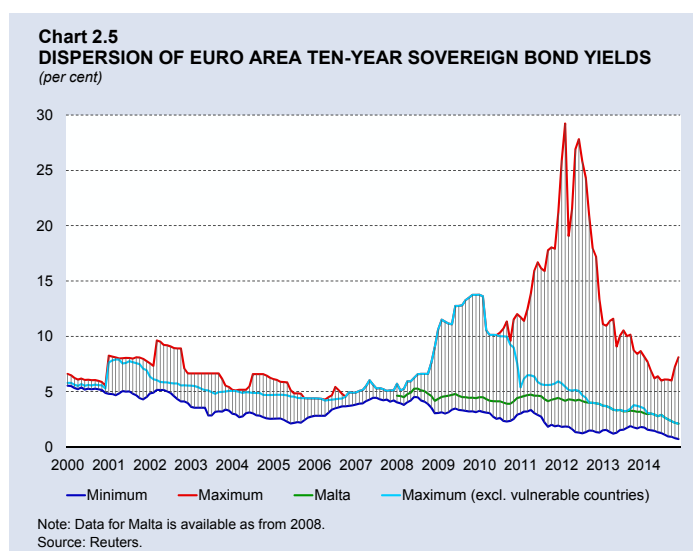
³ The probability of a simultaneous default by two or more large and complex banking groups estimates the probability of a systemic event within a period of one year, as measured by the systemic risk measure. Source: SDW.

⁴ The DJ STOXX Europe 600 index is derived from the STOXX Europe total market index and is a subset of the STOXX Global 1800 index. With a fixed number of 600 components, the STOXX Europe 600 index represents large, medium and small capitalisation companies across 18 countries in Europe.

⁵ VDAX is a measure of the implied volatility of the DAX, which is a blue chip stock market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

⁶ "Financial Stability Review", ECB, November 2014.

The continued efforts towards fiscal consolidation, as well as favourable market sentiment, have eased sovereign debt market conditions. Ten-year sovereign bond yields (excluding vulnerable countries) have dropped, with spreads narrowing (see Chart 2.5).⁷ The support provided by national governments to undercapitalised banks began to unwind, sustaining further improvement in government finances. The new regulatory initiatives, such as the bail-in rules, have also reduced risks emanating from the sovereign-banking sector nexus. During the year sovereign yields of vulnerable countries declined in line with those of other euro area



Member Countries. However, in the fourth quarter of 2014, Greek sovereign yields rose again, casting a shadow over the sustainability of this country's public finances and any consequent feedback loop to the financial system.

BOX 1: THE COUNTER-CYCLICAL CAPITAL BUFFER (CCB)

The pro-cyclical amplification of financial shocks to the real economy, through the banking system and financial markets, has been one of the most destabilising elements of the global financial crisis. Indeed, an economic downturn, following a period of excess credit growth, can lead to large losses in the banking sector and spark a vicious circle. Steps taken by credit institutions to strengthen their balance sheets can constrain credit supply to the real economy, thus exacerbating the economic downturn and further weakening their balance sheets. The pro-cyclical amplification of shocks highlights the importance of the build-up of capital buffers during a cyclical upturn, when the risks of system-wide stress are escalating. Such additional capital buffers will help credit institutions to absorb unexpected losses while continuing to provide credit to the real economy during a downturn.

The counter-cyclical capital buffer (CCB) was proposed by the Basel Committee for Banking Supervision (BCBS) to increase the resilience of the banking sector to negative shocks.¹ The CCB aims to address cyclical systemic risks through a time-varying buffer added on top of the minimum capital requirement and the conservation buffer.^{2,3} The framework also includes the reciprocity principle, which is designed to make the CCB more effective and to ensure a level playing field between domestic and foreign banks, which operate in more than one jurisdiction.⁴

¹ BCBS (Dec 2010): Guidance for national authorities operating the counter-cyclical capital buffer.

² Other macro-prudential tools may be opted for in this regard, such as those related to the leverage and loan-to-value ratios.

³ CRDIV Article 129 requires banks to have a capital conservation buffer of Common Equity Tier 1 capital equal to 2.5 % of their total risk exposure amount, calculated in accordance with Article 92(3) of that Regulation. The buffer will be phased in from 2016 to 2019.

⁴ The reciprocity principle requires banks with credit exposures to foreign countries to hold a buffer that reflects the composition of a bank's domestic and international exposures. An authority in each country sets the buffer requirement that applies to credit exposures located in its jurisdiction. The home authority should ensure that the banks they supervise calculate their buffer requirements based on the geographic location of their exposures.

⁷ Vulnerable countries include Cyprus, Greece, Ireland, Italy, Portugal, Slovenia and Spain.

The counter-cyclical element of the CCB is expected to smoothen the credit cycle whereby, on one hand, an activated CCB may diminish the willingness of banks to lend in an upturn, while, on the other hand, a credit crunch may be avoided as the buffer is released in a downturn.

Nonetheless, the effectiveness of the CCB may depend on the level of voluntary buffers held by banks. The latter may willingly release such buffers (if available) to meet the mandatory CCB, or may prefer to retain such buffers as a safeguard, in which case deleveraging or balance sheet restructuring may follow. However, one may note that issuing new equity may be relatively cheap during a boom and thus, rather than restraining credit growth, banks may easily tap capital markets to increase their capital levels. Alternatively, credit may still grow through other channels as non-financial companies substitute bank credit with credit issued by non-regulated financial intermediaries. This highlights the need for exploring tools, other than the CCB, which target the non-bank financial sector.

The BCBS's Guidance for the CCB was transposed in EU law through the CRDIV framework.⁵ Article 130 of the CRDIV requires Member States to maintain a CCB. Domestically, the relevant articles were transposed through Directive 11 of the Central Bank of Malta and through the Malta Financial Services Authority Banking Rule 15/2015.

Article 136 of the CRDIV regulates the setting up of the counter-cyclical capital buffer rates. The Central Bank of Malta is the designated authority responsible for setting the counter-cyclical capital buffer rate locally. The rate shall be announced on a quarterly basis through publication on the Bank's website, together with a buffer guide reflecting the credit cycle based on the deviation of the ratio of credit-to-GDP from its long-term trend. The CCB is a CET1 capital buffer requirement on domestic exposures and cannot fall below 0%. Normally, it ranges between 0.0% and 2.5% of banks' risk-weighted assets but can also be set at a higher level, which does not necessitate mandatory reciprocity.⁶ If a rate is set above zero, banks are allowed a 12-month lead time from its announcement to build their capital buffers, although in exceptional circumstances the period can be shortened. The CCB of 2.5% can be introduced in a stepped approach over a transitional period between 1 January 2016 and 31 December 2018, yet Member States may opt for a shorter timeframe. The ESRB issued a Recommendation as per Article 135(1) of the CRDIV to provide guidance to designated authorities on setting the CCB rates.⁷ The Recommendation requires designated authorities to measure and calculate, on a quarterly basis, a standardised credit-to-GDP gap in accordance with the BCBS's Guidance.⁸

Chart 1 illustrates the results of a one-sided Hodrick-Prescott filter of the credit-to-GDP ratio for Malta.⁹ The red line represents the smooth version of the original series (blue line). The difference between the series and its long-term trend is captured in the light blue gap histogram.

It can be observed that the credit-to-GDP ratio has been below trend since 2010. For the last quarter of 2014, the ratio is 13 percentage points below the trend. This deviation is only slightly less (negative) than the 14 percentage points, which were recorded in the previous quarter and which coincide with the long-term minimum for the period 1972-2014. In comparison, the most pronounced previous downswing reached just 9 percentage points (in 2005) and took 12 quarters (three years) to return to positive territory. Therefore, based on past experience, it appears rather unlikely that the credit-

⁵ Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

⁶ National authorities can implement a buffer above 2.5% if deemed appropriate in their national context but international reciprocity is voluntary above the 2.5% limit.

⁷ Recommendation of the ESRB of 18 June 2014 on guidance for setting counter-cyclical buffer rates (ESRB/2014/1), OJ 2014/C 293/01.

⁸ See Recommendation of the ESRB of 18 June 2014 on guidance for setting counter-cyclical buffer rates, Annex Part 1 and 2 for the methodology of the calculation of the Credit-to-GDP gap and the benchmark buffer rate.

⁹ Credit represents total bank credit.

to-GDP ratio will exceed its trend before 2018, even though the downward trend may already be slowly reversing. Judging from this indicator alone, it is counter-productive to implement a buffer rate greater than 0%.

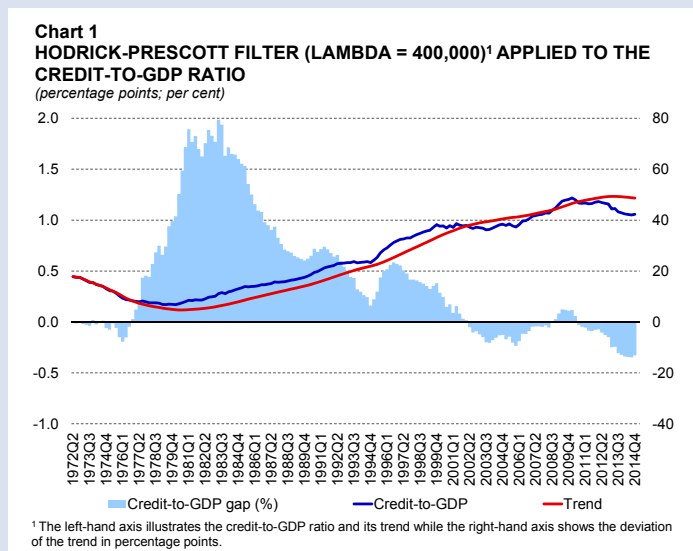
However, even if the credit cycle may indicate that no action is required, it is still possible that diverging trends in specific sectors of the economy exist. For example, although this does not feature in the current analysis, excessive credit growth in one sector could be offset by a credit crunch in another sector.

In this context, the importance of a holistic assessment based on a set of other indicators to assess the extent of excessive credit growth and the use of micro-prudential instruments as a complementary tool is emphasised.¹⁰ Moreover, expert judgment, as well as market signals, should be taken into account when the buffer rate is set.

Thus, in line with international legislation, the Central Bank of Malta shall as from 2016 update and publish the CCB rate on a quarterly basis and will be ready to act once the need arises, taking into consideration the recommendations made by the Joint Financial Stability Board. Moreover, the European Central Bank, as the competent authority for prudential supervision in terms of Article 4 of the SSM Regulation, may, if deemed necessary, apply higher counter-cyclical capital buffer rates than those applied by the national authority.¹¹

¹⁰ CRDIV Article 136 para 3c, states that the designated authority may consider other variables.

¹¹ Article 5.2 of the SSM regulation set out in the Council Regulation No. 1024/2013.



2.2 The domestic environment

In 2014 the Maltese economy continued to perform positively, with growth accelerating further compared with the previous year. Real GDP increased by 3.5%, up from 2.7% in 2013, the second best growth rate amongst euro area Member States behind Ireland, and stood well above the euro area average of 0.9% (see Chart 2.6).

The pick-up in economic activity was entirely driven by domestic demand, as net exports contracted and had a negative impact on real GDP growth. Indeed, all components of domestic demand, except changes in inventories & acquisitions, contributed positively towards real GDP growth (see Chart 2.7).⁸ Private

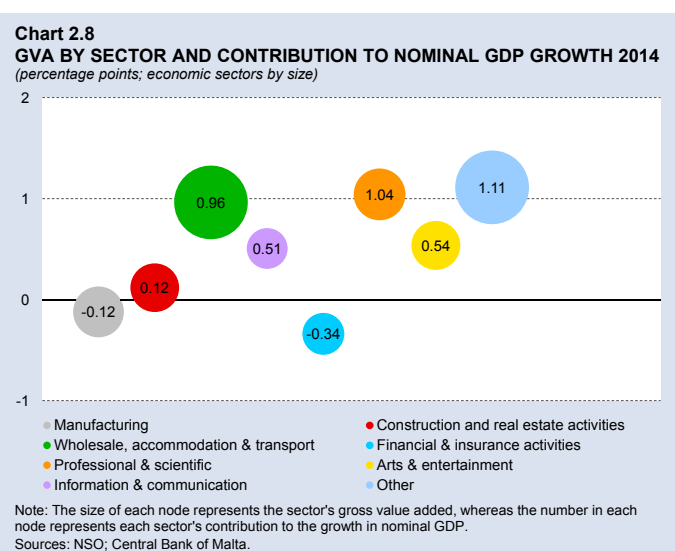
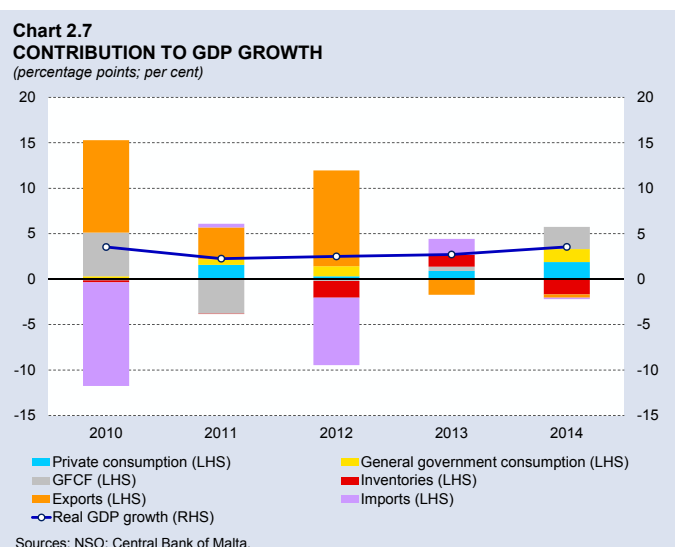
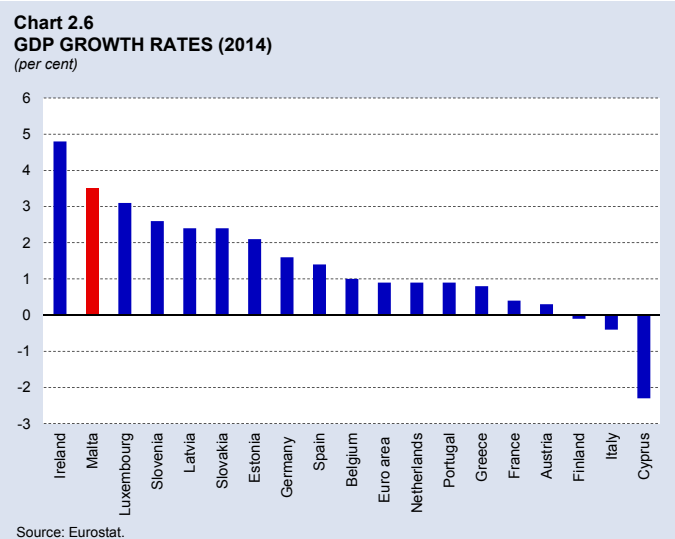
⁸ Changes in inventories & acquisitions include the statistical discrepancy element. As from the second half of 2014, GDP data is based on ESA 2010 standards, with real GDP data compiled using chain-linking methods. Contributions of specific components towards real GDP growth are based on Central Bank of Malta estimates.

consumption growth was the fastest in the last ten years, more than doubling over 2013. Meanwhile, the drop in government consumption recorded in the previous year was reversed. Gross fixed capital formation (GFCF) was the largest contributor to real GDP, driven by non-residential construction and investment in machinery. In 2014 exports of goods and services declined, whereas imports of goods and services increased. However the level of overall exports still exceeded total imports and, as a result, net exports remained positive but at a lower level.

From a sectoral perspective, the gross value added of the service sectors continued to drive nominal GDP growth, with the largest contributors being public administration (captured under the 'other' category) and the professional, scientific & administrative services. On the other hand, the gross value added (GVA) of the financial & insurance activities dropped, reducing its share in nominal output to 6.3%. The real estate and construction sectors registered a gain in their GVA on a year earlier, whereas manufacturing continued to contract (see Chart 2.8).

The labour market remained buoyant during 2014 with continued growth in employment and a consistent downward trend in the number of registered unemployed. Compared with a year earlier, employment growth was 3.1% based on the Labour Force Survey (LFS), whereas the unemployment rate dropped by half a percentage point to 5.9%, the lowest rate recorded since 2002 (see Chart 2.9).⁹

The favourable labour market conditions were reflected in higher compensation of employees, an increase of 5.5% or 1.1 percentage



⁹ The employment growth rate based on ESA 2010 National Accounts data stood at 4.2% in 2014.

points higher than in 2013. The low inflation rate, which dropped to 0.8% from 1.0% in 2013, contributed positively towards gains in compensation of employees in real terms.

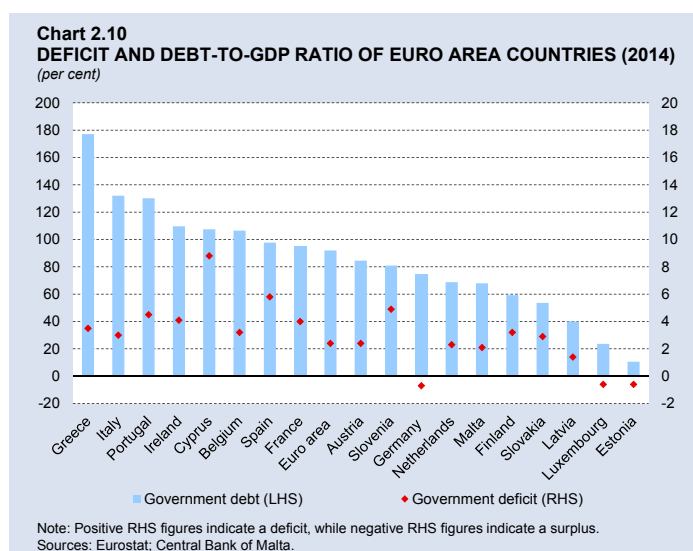
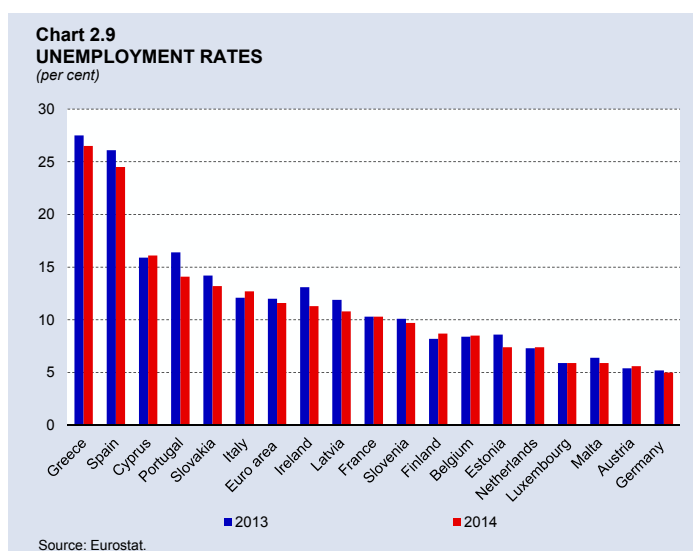
At the same time, productivity in Malta weakened as employment growth outpaced that of real GDP.¹⁰ This contrasts with the euro area where productivity improved as the labour market lagged behind developments in real economic output. The combined lower productivity and higher compensation of employees increased unit labour costs (ULC), which grew at a faster pace than in the euro area, thus exerting a small negative impact on relative price competitiveness in

the domestic economy, especially with respect to other euro area Member States. Internal Central Bank of Malta studies show that in absolute terms Malta's relative competitiveness remains high as evidenced by the positive macroeconomic data, and that the increase in ULC may reflect the sharp shift from direct production to labour intensive services. The nominal Harmonised Competitiveness Indicator for Malta decreased by 2.6%, reversing the loss of competitiveness registered in 2013 and reflecting the depreciation of the euro against the dollar and the pound sterling. In terms of the domestic current account balance, this remained in surplus, while falling only marginally compared with the previous year.

The European Commission's seasonally-adjusted economic sentiment indicator (ESI) for Malta peaked in the third quarter of the year and stood higher on average in 2014 compared with 2013. All components of the ESI contributed towards the improvement in sentiment.¹¹ In the first quarter of 2015 this indicator improved further.

Malta's public finances continued to ameliorate in 2014 as the shortfall between government income and expenditure further narrowed to 2.1% of GDP, down from 2.6% a year earlier, and lower than the average of 2.4% for the euro area (see Chart 2.10). Public debt was also lower at 68.0% of nominal GDP in 2014, compared with 69.2% in the previous year, appreciably lower than the euro area average of 92.0%.

The declining trend in the ten-year government bond yields initiated in 2011 was sustained, with the yield reaching its lowest level



¹⁰ This measure of employment growth is based on ESA 2010 National Accounts data.

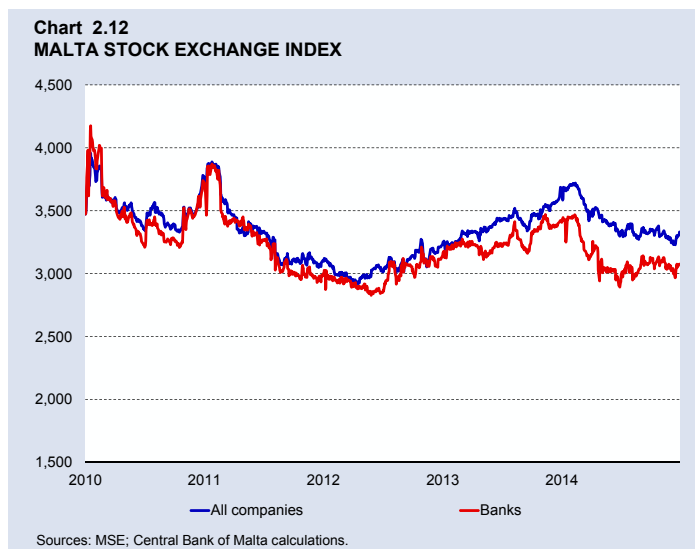
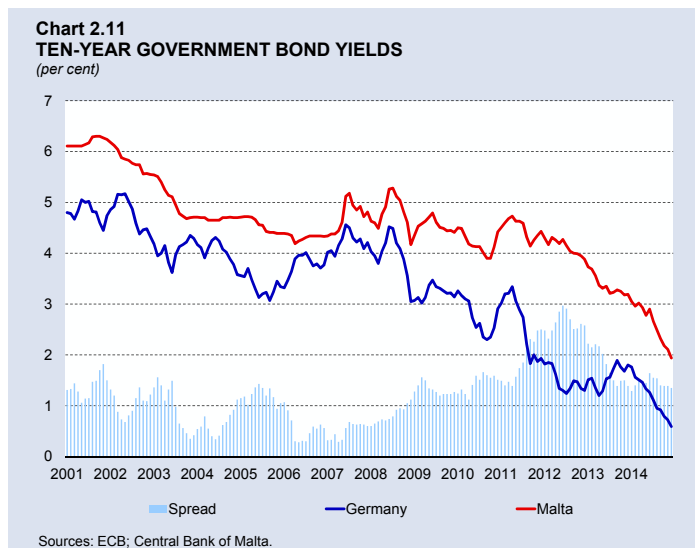
¹¹ The ESI is a weighted average of five different confidence indicators, namely for industry, services, consumers, retail trade and construction.

in 2014 (see Chart 2.11). The spread in relation to the German bund narrowed further, despite the downward trajectory of the latter. Demand for domestic government paper remained strong, with debt issued in 2014 being heavily oversubscribed. The rating for Malta's sovereign debt during 2014 remained unchanged, with the outlook denoted as stable.

The Malta Stock Exchange (MSE) equity index dropped by 9.6% during 2014, mainly driven by banking sector equities, which represent around 52.5% of the MSE's market capitalisation. The sub-index relating to the banks, which is computed by the Central Bank of Malta, stood 10.1% lower in 2014 when compared with 2013 (see Chart 2.12). Lower bank profitability may have contributed to declining share prices. Overall, the market value of traded equities was €2.4 million lower, reaching €50.8 million by year-end. Excluding trading in banking equities, the value of other traded equities stood at €23.1 million, €5.2million less than in 2013. Bank equities accounted for about 55% of total traded equities in value terms.

In contrast, the bond market performed better, as also indicated by the trading activity which increased during the year. During 2014 the trading value of the corporate bond market recovered and increased by nearly one-third to €43.2 million, following a decline reported in 2013. Activity in government bonds trading went up to €836.4 million, or 23.2% higher than in the previous year. Government debt accounted for nearly 89% of the total trading value on the MSE.

The Central Bank of Malta continued to exercise its oversight mandate over the Payment and Securities Settlement Systems in Malta. In this regard, the Bank conducted the third Comprehensive User Assessment on MaltaClear, the local securities settlement system, on behalf of the Eurosystem. The assessment recognised this system's continued eligibility for its use in the Eurosystem's monetary operations. While the total number of institutions participating directly in Target2 (T2) remained five, payments traffic through T2 registered an increase in 2014 with a total value of €139.2 billion, with interbank transactions accounting for almost 97% of the total in value terms. The remainder involved customer payments, which amounted to 62,200 transactions with a total value of €4.4 billion.



The positive performance of the domestic economy is expected to extend well into 2015. Real GDP is forecast to grow at a slightly faster rate of 3.6%. Domestic demand is expected to be the main driver behind economic growth. External demand is expected to drag down economic growth as exports are forecast to grow at a lesser rate than imports. Projections for employment indicate further growth, albeit at a slower pace than reported in 2014, whereas the unemployment rate is anticipated to drop further to 5.8% in 2015, while inflation forecasts point towards a pick-up to reach 1.4% by 2015.

3. FINANCIAL STABILITY CONDITIONS

This Chapter reviews the financial stability conditions of core domestic banks, regarded to be the most relevant for the domestic financial system with their extensive links to the Maltese economy. Section 3.1 assesses the developments in corporate and household sectors, with reference to the level of indebtedness and related credit risk. Section 3.2 reviews the main asset holdings of core domestic banks and assesses their potential risks, whereas Section 3.3 explores the core domestic banks' funding structures.

After following an upward path in previous years, the increase in non-performing loans (NPL) ratio tapered off, as economic conditions strengthened further, with lending by core domestic banks gaining momentum. Banks' assets also expanded, with their foreign asset exposures directed at highly rated countries, while sovereign holdings consisted mainly of domestic government paper. The banks' funding conditions remained healthy, underpinned by the flow of customer deposits, which accelerated during the year. Although wholesale funding and recourse to the Eurosystem increased, these sources of funds continued to be low in relation to core domestic banks' total liabilities. In light of developments mentioned above, the financial stability conditions of core domestic banks improved.

3.1 Developments in corporate and household sectors

3.1.1 The corporate sector

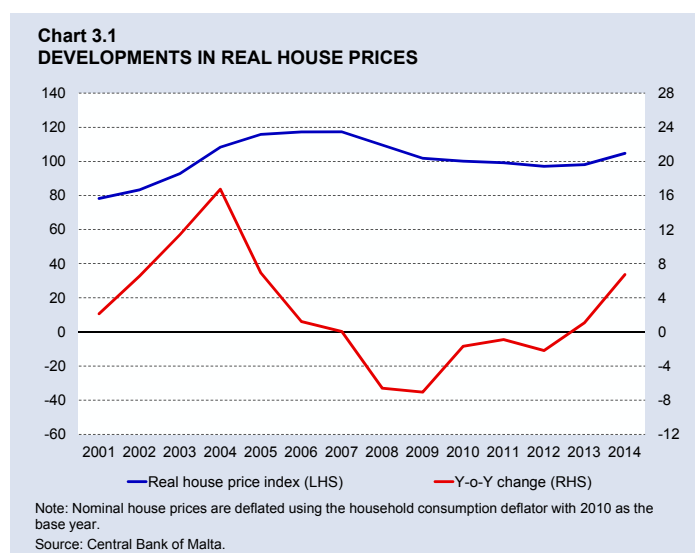
In 2014 the nominally-measured operating surplus of the corporate sector increased by 4.5%, compared with a 5.8% rise in 2013. The slowdown mainly reflected lower profits posted by the financial sector.¹ The non-financial corporate sector on its own grew its operating surplus by 7.3%, which was slightly higher than the 7.1% growth in 2013.

Construction and real estate

The overall operating surplus of firms in the construction and real estate sectors continued to expand, albeit marginally by 0.8% in 2014, mostly driven by the real estate sector. Construction firms also contributed but to a lesser extent.

These results were supported by developments in the Advertised Property Price Index compiled by the Central Bank of Malta, which showed an increase of 6.7% in real house prices in 2014, the highest growth reported since 2005 (see Chart 3.1).² In nominal terms, house prices increased by 7.0%, and for the first time the property price index surpassed the pre-crisis peak that had been reached in mid-2007.

Nevertheless, the price-to-income ratio, which compares the overall median house price based on advertised properties with the compensation per employee as compiled by the Central Bank of Malta,



¹ Source: National Statistics Office (NSO).

² The Central Bank of Malta's property price index is based on advertised property prices. These are indicative of the sellers' expectations, and are generally biased upwards and are accentuated further during recovery periods.

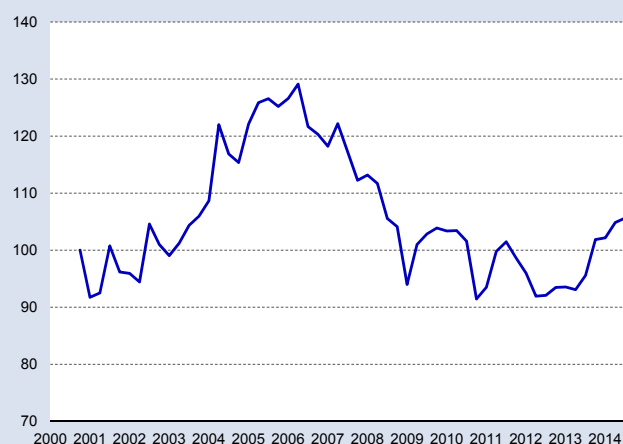
indicates that, although household affordability somewhat deteriorated throughout 2013 and 2014, this was still generally in line with pre-peak periods (see Chart 3.2). Furthermore, this reduction in affordability, which is measured on the income of a single employee, is partly being offset by increasing household income through higher female participation in the labour market.

Growth in house prices was relatively higher in Malta than in the euro area, where it averaged 0.2% in 2014 (see Chart 3.3). Despite wide divergences in real estate market conditions across the European Union, conditions generally improved as most countries reported smaller declines in property prices or stronger growth rates.

Respondents to the Central Bank of Malta's Real Estate Market Survey reported an increase in sales of residential properties, particularly apartments in 2014.³ Over 70% of the respondents indicated that residential property prices are correctly priced, a significant gain on the 35.4% reported in 2013 (see Chart 3.4). Meanwhile, sales of commercial property remained relatively stable. Most respondents continued to perceive commercial property as being overpriced, with 43.2% considering them correctly priced, compared with 39.3% in 2013.

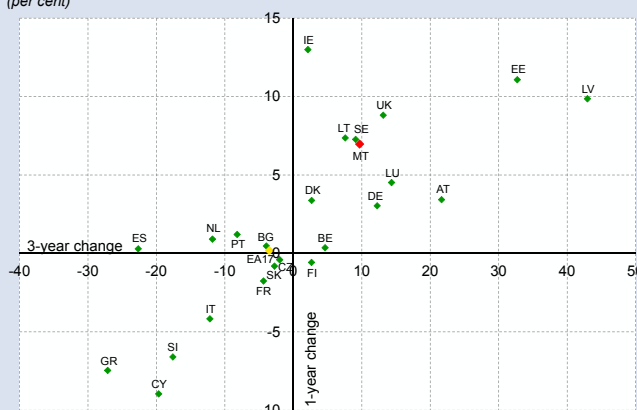
These perceptions are consistent with the general improvement in other indicators of the property market, such as the number of permits issued by the Malta Environment and Planning Authority. Following six years of steady decline in the number of permits issued, this trend was halted as issued permits increased by 8.6% in 2014. All types of dwellings, except for terraced houses, reported a rise in the number of permits. Indeed,

Chart 3.2
MEDIAN PROPERTY PRICE-TO-INCOME RATIO (2014)



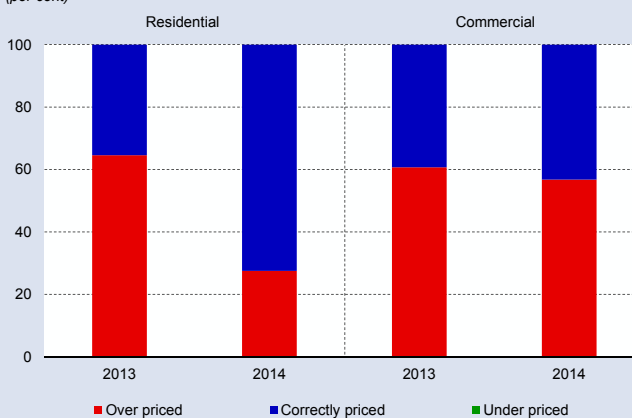
Source: Central Bank of Malta.

Chart 3.3
CHANGE IN NOMINAL RESIDENTIAL PROPERTY PRICES (2014)
(per cent)



Data refer to total dwellings in all countries (national differences may exist). Data for CZ and LV refer to 2013. Data for HR, PL and RO are not available. Source: ECB and ECB calculations (ESRB risk dashboard).

Chart 3.4
VALUATION PERCEPTIONS OF RESIDENTIAL AND COMMERCIAL PROPERTIES
(per cent)



Source: Central Bank of Malta's Real Estate Market Surveys.

³ The Real Estate Market Survey is conducted biannually by the Central Bank of Malta among a sample of real estate agents.

this reversal mainly reflects developments in the apartments' category, in which permits rose by 7.7% and accounted for 75% of permits issued. This outcome is in line with the Government's aim of reviving the real estate market, with measures directed to first time buyers.

The growing confidence in the real estate market is also reflected in the Construction Confidence Index for Malta published by the European Commission. While remaining in negative territory, this index improved significantly throughout 2014 and turned positive in the beginning of 2015.

Other non-financial corporate sectors

The operating surplus of other non-financial corporate firms advanced by 8.5% in 2014, with most sectors reporting improved profits. The main economic sector with the highest growth rate of 27.4% was the transportation & storage sector. Very high growth rates of 16.1% and 17.0% were reported in professional, scientific & technical activities and in the information & communication sectors, respectively.

The gain of 13.8% in operating surplus of the accommodation & food services sector was underpinned by the accommodation component. This is further corroborated by the Malta Hotels and Restaurants Association's survey results, which show an improvement in gross operating profit per available room for the main hotel categories (3-star, 4-star and 5-star hotels). This was primarily driven by higher occupancy rates, ranging between 70.4% and 77.7%, on the back of higher tourist traffic and increasing tourist spending.

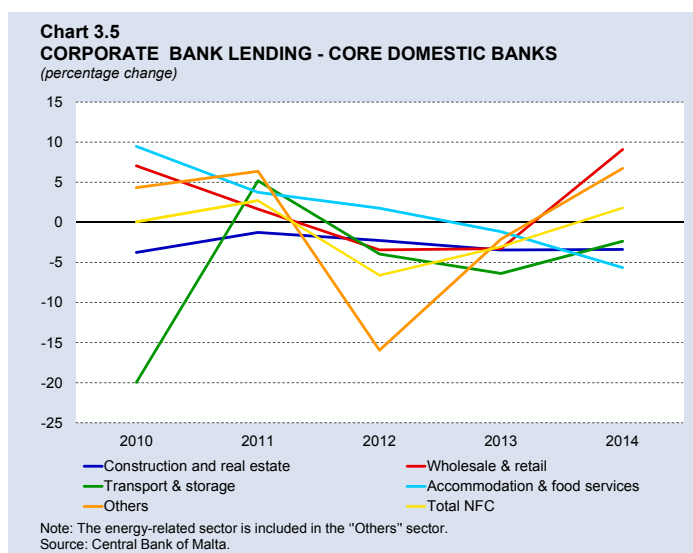
In addition, the arts, entertainment & recreation sector registered stronger operating surplus, up by 7.1%, while the wholesale and retail trade sector registered growth of around 2.9%.

In contrast, manufacturing recorded a drop of 4.6% in operating surplus, though this represents a much less negative performance than the contraction of 28.6% in 2013. This drop reflected the decline of 5.5% in the Index of Industrial Production during 2014. Meanwhile, the electricity, gas, steam & air-conditioning supply industry continued to contribute negatively to growth in aggregate operating surplus.

Corporate indebtedness and concentration

Following two consecutive years of contraction in resident corporate lending, core domestic banks reported an expansion of 1.8% in 2014 (see Chart 3.5). The increase was driven by lending to the energy sector. Credit granted to this sector grew by more than half during the year. Meanwhile, lending to the wholesale & retail trade also rose strongly by 9.1%. Other sectors which reported higher borrowing were public administration & defence, human health & social work activities and administrative & support service activities, up by 11.3%, 7.9%, and 2.8%, respectively. On the other hand, lending to the accommodation & food services sector, and the transportation & storage sector continued to contract, down by 5.7% and 2.4%, respectively.

In the context of improved conditions in the property market, core domestic banks remained prudent and maintained tight credit standards to reduce exposure to the sector. Indeed, lending to the resident construction sector was curtailed, dropping by a further 10.4%. However, lending to the resident



real estate sector rose by 13.0%, amounting to 10.5% of total resident corporate loans in 2014, up from 9.5% in 2013. Combined lending to the construction and real estate sectors contracted by 3.4%.

An expansion in corporate lending was reported while credit standards were maintained at tight levels, as submitted by respondents of the Bank Lending Survey (refer to Box 2). Furthermore, the cost of borrowing by businesses declined marginally, as indicated by the weighted average interest rate charged by core domestic banks, standing at 5% as at end-2014 – 0.1 percentage point lower than a year earlier.

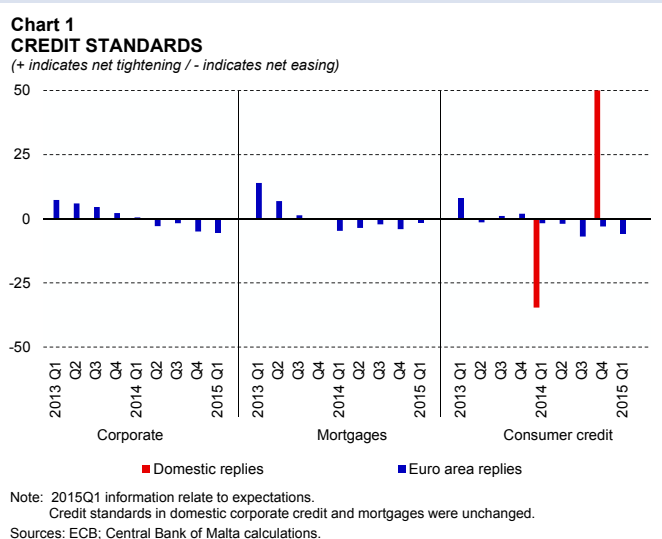
BOX 2: BANK LENDING SURVEY RESULTS

The euro area Bank Lending Survey (BLS) adopts a bottom-up approach in examining credit market conditions, particularly with regard to the lending behaviour of the surveyed banks.¹ The quarterly BLS encapsulates banks' views regarding changes in the supply and demand for loans through credit standards, as well as credit terms and conditions.^{2,3} A distinction is made between loans to enterprises, mortgages and consumer credit. In Malta, four out of five core domestic banks participate in the survey, covering a major share of the resident credit market. Domestic responses are weighted and aggregated in the euro area BLS results.^{4,5}

Credit supply conditions

The tightening in corporate credit standards since 2011 was sustained by Maltese respondents throughout 2014 and is set to continue in the first quarter of 2015 (see Chart 1). Such tight levels were maintained owing to exposures towards particular sectors, the increasing bank capital requirements following the implementation of the new regulatory regime and, to a lesser extent, the perceived risk in the general economy. The stricter corporate credit standards were accompanied by some easing in loan interest rate margins.

In contrast, for the first time since the second quarter of 2007, euro area banks reported a net easing of corporate credit standards during the second quarter of 2014. This reflected a relaxation in banks' cost of funds and balance sheet constraints, coupled with a reinforced liquidity position in view of improved access to market funding. Accordingly, euro area banks markedly reduced their interest margins on loans and their non-interest rate charges. This easing was further translated into more favourable non-price terms and conditions. Looking forward, at a euro area level, corporate credit standards are expected to ease even further.



¹ The BLS is addressed to senior loan officers of a representative sample of euro area banks. In the case of Malta, the views expressed by respondents on economic conditions may not necessarily reflect the overall macroeconomic environment.

² Credit standards are the internal guidelines or criteria which reflect a bank's loan policy.

³ Credit terms and conditions of a loan refer to the specific obligations agreed between the lender and the borrower.

⁴ Net percentages are used to analyse trend estimates. Data are published on the ECB's Statistical Data Warehouse (SDW).

⁵ The weighting scheme is based on the amounts outstanding of loans of individual banks in the sample.

With regard to mortgage credit extended to households, the surveyed banks in Malta kept their credit standards unchanged in 2014 and were not anticipating any changes in the first quarter of 2015. Since 2012, the surveyed domestic banks have constantly narrowed their margins on mortgage loans, until the third quarter of 2014, when banks widened their margins. Respondents also widened somewhat the margins on riskier loans. As a result, these changes had a neutral impact on credit standards throughout 2014.

On balance, credit standards for corporate lending and mortgages remained unchanged for domestic BLS respondents.

Conversely, in the euro area the rather high level of tightening until the third quarter of 2013 was completely smoothed out in the final quarter of that year, after which euro area banks reported a net easing in mortgage credit standards through a significant reduction in margins on average housing loans. This reflected higher competitive pressures. This positive trend is expected to continue through the first quarter of 2015.

Consumer credit standards reported by Maltese BLS respondents were relaxed at the beginning of 2014 and were kept stable in the subsequent two quarters, but were then tightened in the last quarter of the year. This followed a period when consumer credit standards, were unchanged at tight levels since late 2009. A worsening in creditworthiness of loan applicants and, to a lesser extent, a more reduced demand for credit-financed consumption were the predominant factors, which led to such tightening. Tougher lending affordability measures were also implemented throughout 2014. During the first quarter of 2015, Maltese BLS banks were expected to maintain consumer credit standards unchanged at tight levels.

In contrast, following an extensive period of tightened consumer credit standards in the euro area, credit standards were gradually and consistently relaxed throughout 2014. Positive developments in banks' funding costs and balance sheet constraints, as well as alleviated competitive pressures, contributed to narrower margins on average consumer loans. Consumer credit standards in the euro area were anticipated to ease further during the first quarter of 2015.

Credit demand conditions

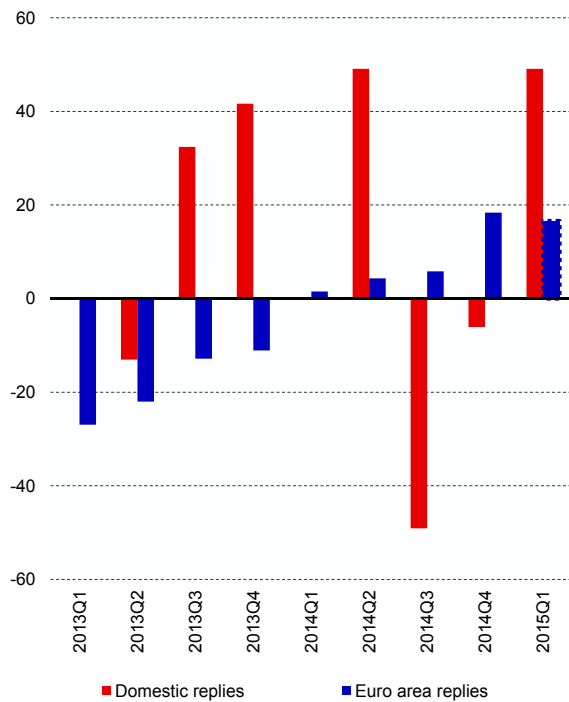
During the first half of 2014, Maltese BLS banks reported a net increase in corporate loan demand, (see Chart 2). This was mainly in line with corporate funding needs for higher fixed investment and inventories, along with working capital needs. However, throughout the second half of 2014, Maltese BLS banks registered a net decline in corporate loan demand, reflecting a reversal in fixed investment needs, along with intensified competition between lenders. BLS banks anticipated higher corporate loan demand in the first three months of 2015 in view of the favourable terms and conditions being offered.

This mirrored developments in the wider euro area. Indeed, after a lengthy period of subdued corporate credit demand, in 2014 euro area banks reported a rise in loan demand, attributable to an increased need for financing mergers and restructuring.

In Malta mortgage credit demand continued to display strong upward momentum in 2014, reflecting rising consumer confidence, improved housing market prospects and higher household savings (see Chart 3). Specific measures aimed at first time buyers also featured as one of the main drivers for higher demand. Mortgage demand was expected to remain stable in the first quarter of 2015.

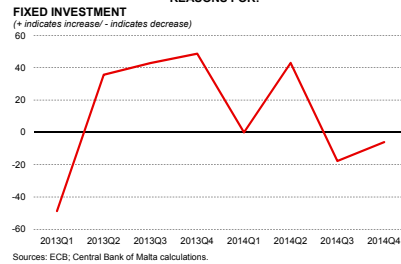
Similarly, throughout 2014 euro area banks witnessed a reinforced mortgage credit demand, which is set to persist in the first months of 2015. As also observed in Malta, positive developments in housing

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

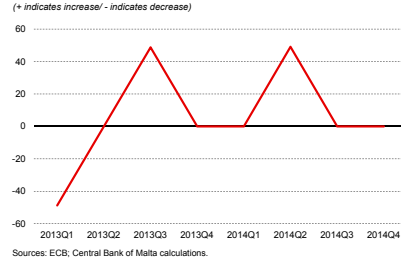


Note: 2015Q1 information relate to expectations.
Sources: ECB; Central Bank of Malta calculations.

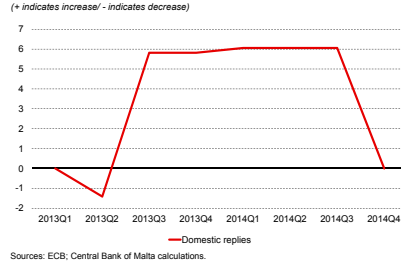
REASONS FOR:



INVENTORIES AND WORKING CAPITAL

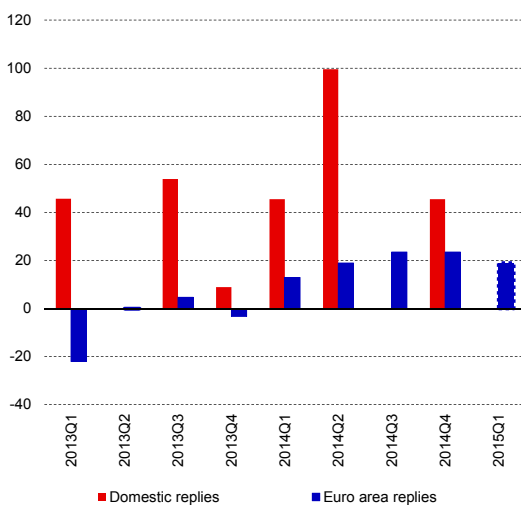


DEBT RESTRUCTURING



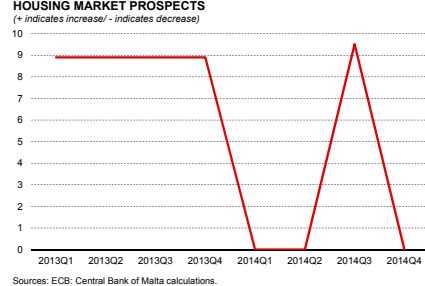
Sources: ECB; Central Bank of Malta calculations.

Chart 3
MORTGAGE CREDIT DEMAND
(+ indicates increase/ - indicates decrease)

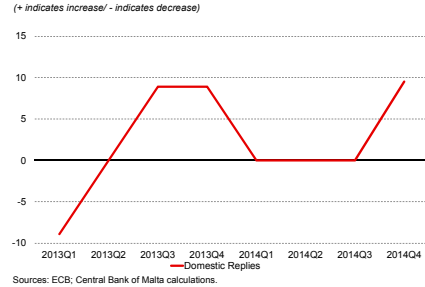


Note: 2015Q1 information relate to expectations.
Sources: ECB; Central Bank of Malta calculations.

REASONS FOR:



CONSUMER CONFIDENCE

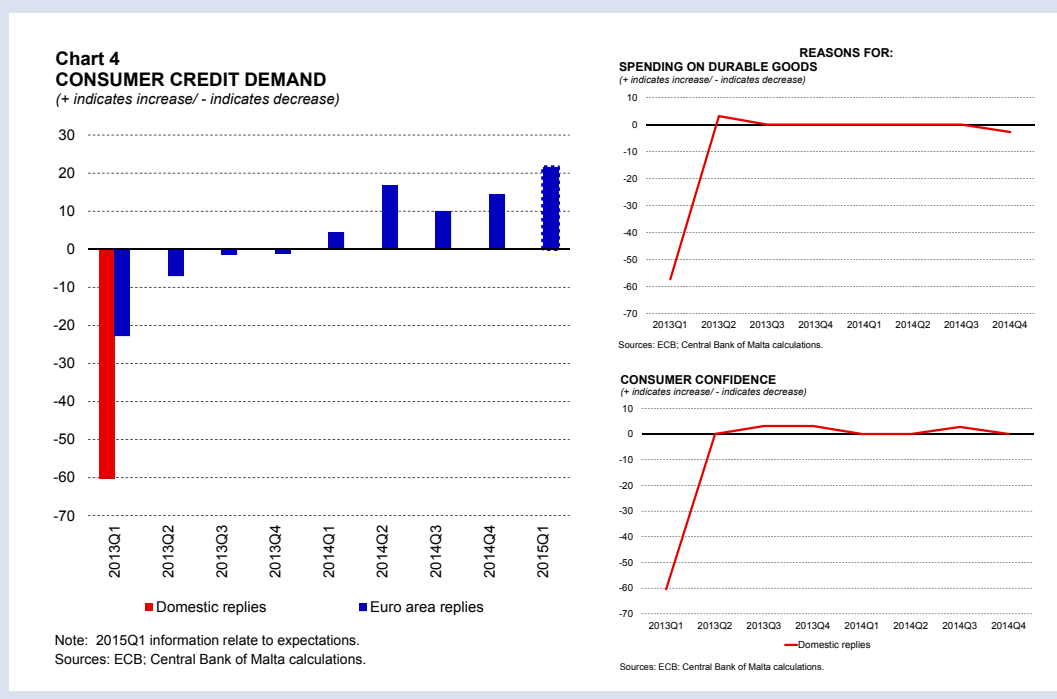


Sources: ECB; Central Bank of Malta calculations.

market prospects and a boost in consumer confidence were the main factors driving the increased mortgage demand.

Following the decline reported by Maltese BLS respondents in the first quarter of 2013, on balance, demand for consumer credit remained stable in 2014 (see Chart 4). According to BLS respondents, lower spending on durable consumer goods, as well as competitive pressures from other banks, maintained a weak demand for consumer credit in 2014 and was expected to remain at this level in the first quarter of 2015.

After a prolonged negative period, euro area consumer credit demand turned positive during 2014, mainly as a result of higher consumer spending and improved consumer confidence. For the first three months of 2015, euro area banks anticipated a marked increase in demand for consumer loans.



From a risk perspective, core domestic banks continued to reduce the level of concentration in the loan portfolio, particularly with the share of construction narrowing to 19.4% of resident corporate loans from 22.1% a year earlier (see Chart 3.6). This slow decline has been in evidence since 2010, when lending to this sector accounted for 23.8%. Meanwhile, the proportion of real estate loans increased by 1 percentage point to 10.5%, while the share of lending to the wholesale & retail trade sector went up by 1.4 points to 20.6% of resident corporate loans, becoming the largest corporate concentration for credit granted to corporates by core domestic banks.

The resident corporate sector also relies on the capital market as an alternative source of funding. This, however, constitutes a relatively low proportion of total corporate indebtedness, equivalent to just 4.9% of total debt (see Chart 3.7).⁴ This is mainly a reflection of the local corporate sector's structure, which is primarily characterised by micro, small and medium-size enterprises that largely rely on bank financing.

Corporate indebtedness increased by 1.5%, mostly owing to a higher resort to bank loans, while the outstanding value of non-financial corporate bonds rose by 11.3%.⁵ Nevertheless, as a share of GDP,

⁴ Total indebtedness of non-financial corporates excludes holding companies, given that the latter are classified as part of the financial sector following the introduction of ESA 2010.

⁵ Total corporate indebtedness includes bank credit, bonds and funding from non-financial and other stakeholders.

corporate indebtedness contracted from 161.2% in 2013 to 156.3% in 2014 owing to the relatively faster rate of economic growth. Around half of corporate loans originate from other resident non-financial corporations, which include intragroup lending, while a third of such debt is obtained from resident banks. In 2014 the nominal value of bonds issued by the corporate sector in Malta and listed on the Malta Stock Exchange increased by 37.0%.⁶

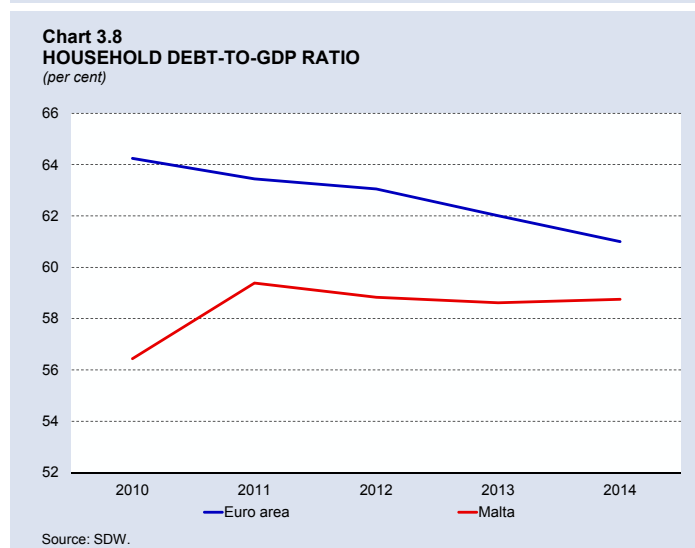
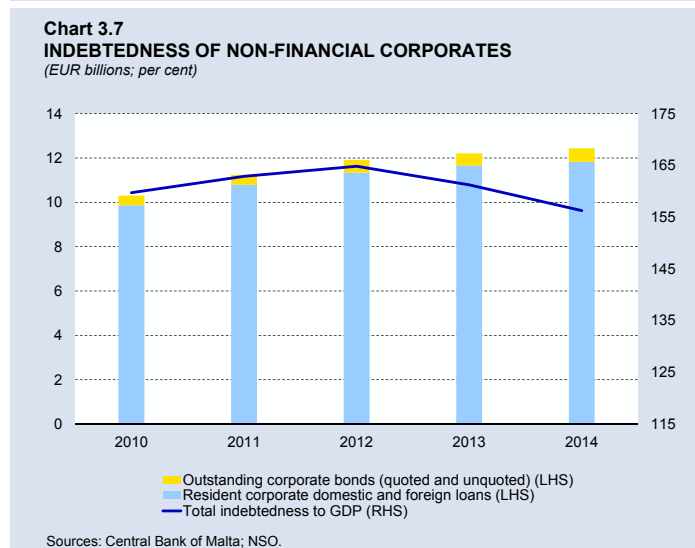
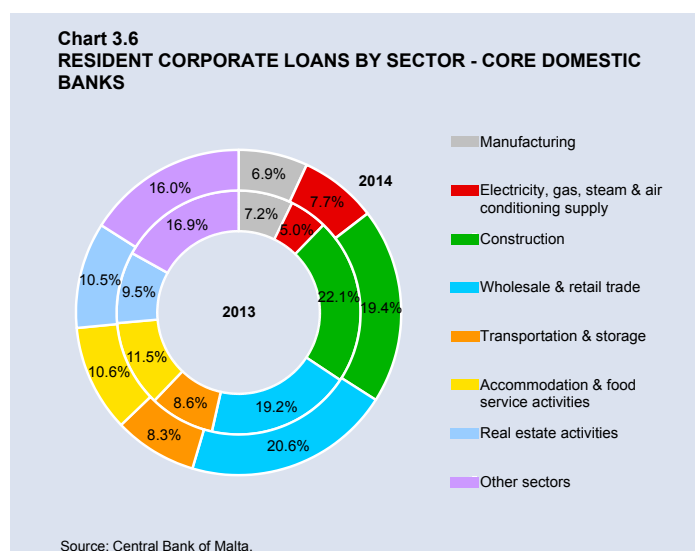
Outstanding corporate loans granted by core domestic banks totalled 51.3% of GDP in 2014, down from 53.0% in 2013. Meanwhile, loans to the resident corporate sector from non-core domestic banks accounted for another 2.2% of GDP, while 0.1% of GDP was granted by international banks.

3.1.2 The household sector

Household indebtedness

Following a decade of positive yet decelerating growth, lending by core domestic banks to resident households picked up, rising by 7.3% in 2014, or 2.4 percentage points higher than in 2013. This growth was solely driven by mortgage lending, up by 9.6% to €3.6 billion in 2014, as consumer credit contracted further, falling by 3.8% to €652.3 million. Relative to GDP, household indebtedness increased by just 0.2 percentage point during 2014 to 58.8%, remaining below the euro area average of 61.0%, while the gap between the two has narrowed slightly (see Chart 3.8).

In line with cuts in policy rates by the ECB, as well as banks' specific measures targeting first-time buyers, the households' cost of borrowing narrowed by 0.4 percentage point to 3.5% in 2014



⁶ Should one include the holding companies, the increase in outstanding bonds would amount to €166.0 million or 31.2%. Holding companies account for around 83% of total corporate bonds (excluding bonds issued by the banking sector). The new bonds were mainly issued by firms in construction and hotel industries.

(see Chart 3.9). Indeed, lower borrowing costs were almost entirely attributable to a lower weighted average interest rate on mortgages, which stood at 3.2% in 2014, compared with 3.6% in the previous year. Meanwhile, the weighted average interest rate for consumer credit charged by core domestic banks remained unchanged at 5.6%. In view of the above, and as a result of higher household disposable income, the interest burden for households dropped to 3.1% in 2014 from 3.3% in 2013.⁷

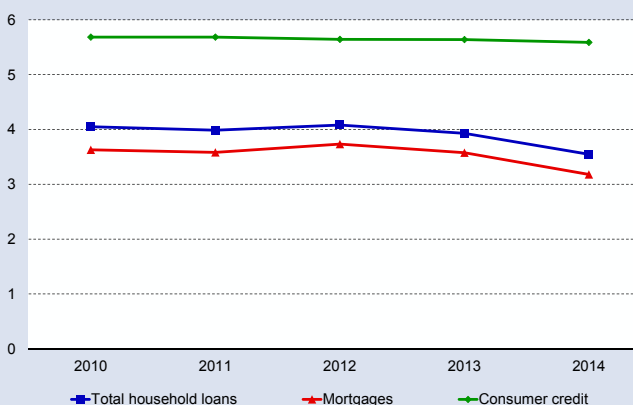
Household net financial wealth expanded by 15.2%, further enhancing households' credit worthiness (see Chart 3.10). This improvement mainly reflected greater holdings of securities and shares, and to a lesser extent, higher deposits. This was, however, partly dampened by a larger take-up of loans.

Developments in the distribution of household loans by income bracket remained broadly stable, skewed towards relatively high income earners, thus supporting favourable household credit worthiness.⁸ The proportion of loans held by households with an annual income exceeding €30,000 increased to almost 47% of the total, 1.7 percentage points higher than in 2013. Loans granted to households with an income of between €10,000 but less than €30,000 accounted for around half of the loans, while low income households held a relatively low proportion of loans, equivalent to less than 3% (see Chart 3.11).

3.1.3 Quality of bank loans

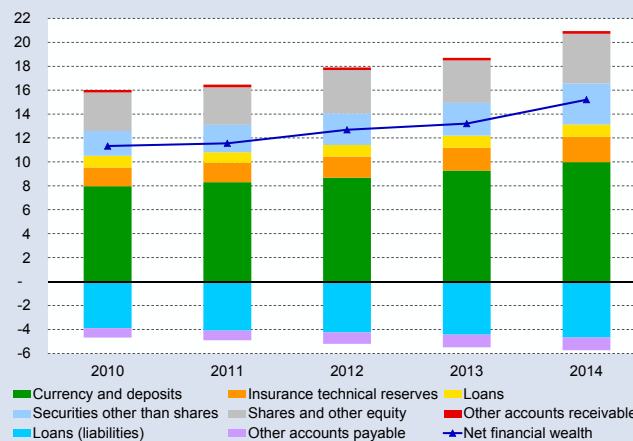
The core domestic banks' NPL ratio increased to 9.5% in June 2014 from 9.2% in December 2013, but eased to 9.3% by end-2014. The

Chart 3.9
WEIGHTED AVERAGE INTEREST RATES ON RESIDENT HOUSEHOLD LOANS - CORE DOMESTIC BANKS
(per cent)



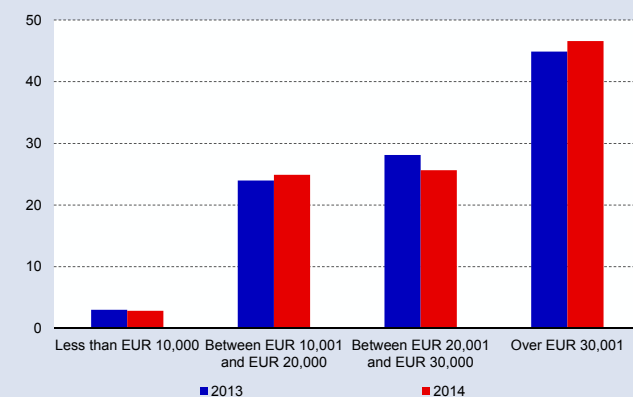
Source: Central Bank of Malta.

Chart 3.10
NET HOUSEHOLD FINANCIAL WEALTH
(EUR billions)



Source: Central Bank of Malta.

Chart 3.11
DISTRIBUTION OF HOUSEHOLD LOANS BACKED BY RESIDENTIAL PROPERTY BY INCOME BRACKET - CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

⁷ The interest burden refers to the average household interest payments as a share of the Central Bank of Malta's estimate of households' disposable income.

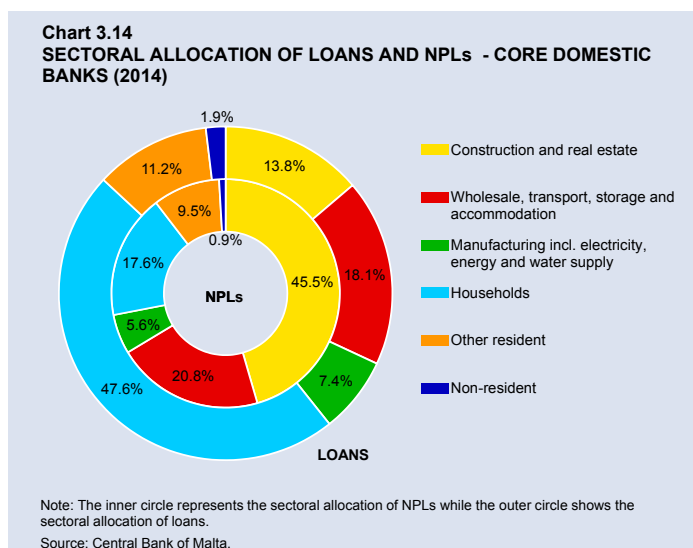
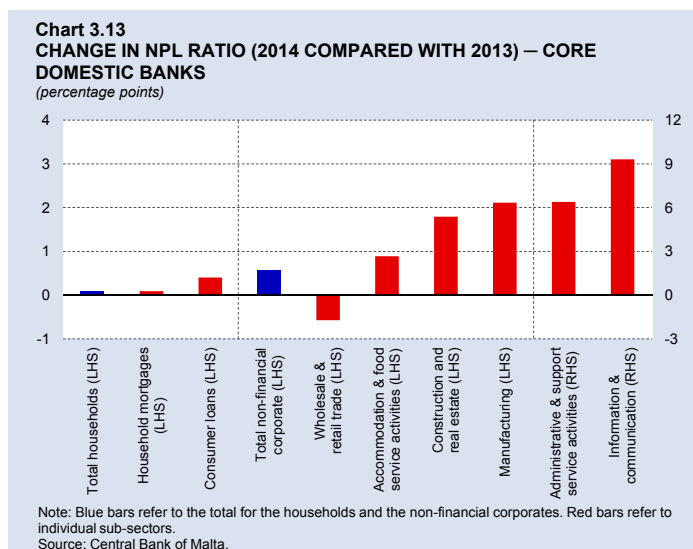
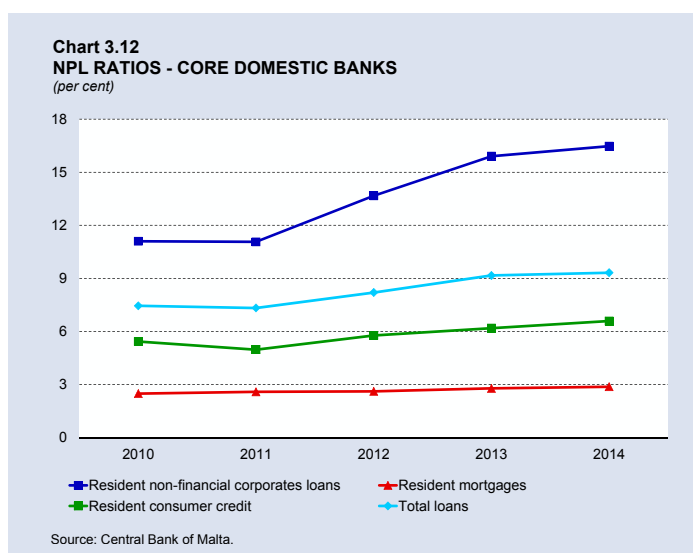
⁸ The loans considered in this paragraph are household loans backed by residential property.

marginally higher NPL ratio resulted from an increase in NPLs, mostly from the corporate sector (see Chart 3.12).⁹

During 2014 the resident non-financial corporate NPLs as a ratio of resident non-financial corporate lending increased at a slower pace, by 0.6 percentage point to 16.5%. The information & communication and administrative & support service activities sectors reported the largest increase in their respective NPL ratios (see Chart 3.13). However, these sectors represent a low proportion of resident non-financial corporate NPLs, at 1.5% and 3.4%, respectively.

The rise in NPLs was also driven by the construction and real estate sector, which, however, was much more contained compared with the previous year. Indeed, its NPL ratio increased by less than 2 percentage points compared with the rise of almost 5 percentage points in 2013. This reflected positive developments of the real estate sector in Malta, as well as the banks' prudent lending practices adopted in recent years.

The household NPL ratio remained broadly stable at 3.4%, as both household NPLs and loans to households increased in tandem. More specifically, the mortgages NPL ratio remained broadly stable at 2.9% while the consumer credit NPL ratio increased by 0.4 percentage point to 6.6%, as consumer credit dropped (see Chart 3.12). The household sector accounted for 47.6% of total loans, but only 17.6% of NPLs (see Chart 3.14). The good quality of household loans continued to be supported by favourable macro-financial conditions, including improved net financial wealth, strong employment growth, low unemployment rates and lower interest rates.



⁹ Almost all NPLs pertain to resident loans, with non-resident NPLs remaining stable, amounting to less than 1% of total NPLs reported.

3.2 Other asset holdings

3.2.1 Foreign asset holdings

In 2014 core domestic banks reported a significant increase in foreign asset holdings, up by almost 70%, reaching €5.0 billion. These holdings now represent 29.2% of their total assets, 9.9 percentage points higher than the level at the end of 2013. The increase is attributable to greater holdings of assets issued in both euro area and non-euro area countries, each increasing by around €1 billion. The rise in foreign asset holdings reflected placements with banks and, to a lesser extent, securities.

Total foreign asset holdings are mainly composed of placements with banks, which, at the end of 2014, amounted to €3.5 billion or 70.4% of total foreign asset holdings. Other private holdings accounted for €1.0 billion or 20.1%, while the remainder consisted of sovereign debt holdings.

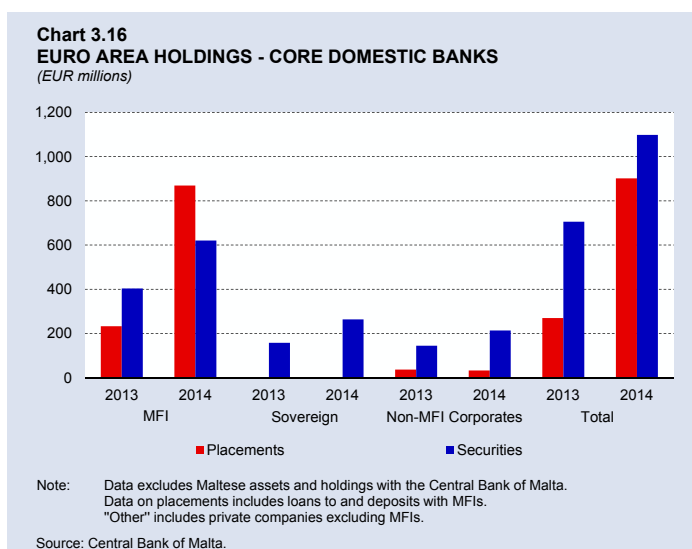
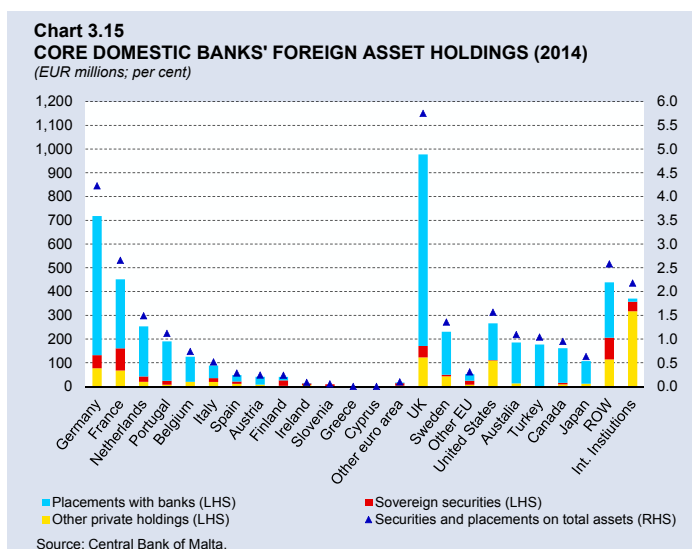
The majority of foreign asset holdings remain in highly-rated economies, most notably the United Kingdom, Germany, France, the United States and the Netherlands, which together account for 53.7% of total foreign asset holdings (see Chart 3.15). Holdings of assets issued in vulnerable countries amounted to 7.1% of total foreign asset holdings at end-2014, up from 5.9% in 2013.¹⁰ Intragroup holdings account for a significant proportion of such exposures.

Focusing on euro area asset holdings, the increase consisted mainly of higher placements with banks, up by €636.4 million. The rest is attributable to greater securities holdings. Meanwhile, from a counterparty perspective, over 80% of the increase consisted of assets issued by monetary financial institutions (MFI) in which such holdings expanded to around €1.5 billion (see Chart 3.16). Sovereign exposures rose by 67.5% to €263.9 million. Despite this expansion, holdings of sovereign debt issued by vulnerable euro area countries remained marginal, equivalent to 1.2% of total foreign asset holdings or 0.3% of total assets. Exposures to non-MFI counterparties went up by 35.9% to €246.1 million, which is equivalent to 1.4% of total assets.

3.2.2 Foreign exchange exposure

During 2014 loans and securities denominated in foreign currencies rose by over a third, to €2.7 billion equivalent to 15.9% of total assets. Of these, about two-thirds were securities. On the liabilities side,

¹⁰ Vulnerable countries include Cyprus, Greece, Ireland, Italy, Portugal, Slovenia and Spain.



deposits denominated in foreign currency increased by 14.5% to €2.2 billion and accounted for 13.2% of total liabilities.

When netting assets with liabilities in each foreign currency, core domestic banks held a long position (assets greater than liabilities) in Swedish Krona (SEK), US Dollar (USD) and Australian Dollar (AUD), equivalent to 35.0%, 31.7% and 14.8% of Tier 1 capital, respectively, and a short position in Pound Sterling (GBP), equivalent to 31.2% of Tier 1 capital. Net exposures in other currencies, including the Japanese Yen (JPY) and Danish Krone (DKK), were limited, each standing at less than 2% of the original own funds. However, core domestic banks hedged such positions off balance sheet through currency swaps and forward contracts. In this regard, the banks improved their risk profile in case of fluctuations in foreign exchange markets and concurrently enhanced their return.

Towards the end of 2014 and in early 2015, the Swiss Franc (CHF) and the Russian Rouble (RUB) experienced large swings in the exchange rate against major currencies, triggered by specific events. This led a number of banks across the European Union to incur considerable losses. These foreign exchange events, however, did not impact core domestic banks as they were not exposed to the RUB, while their exposure in CHF was limited to just 0.2% of original own funds.

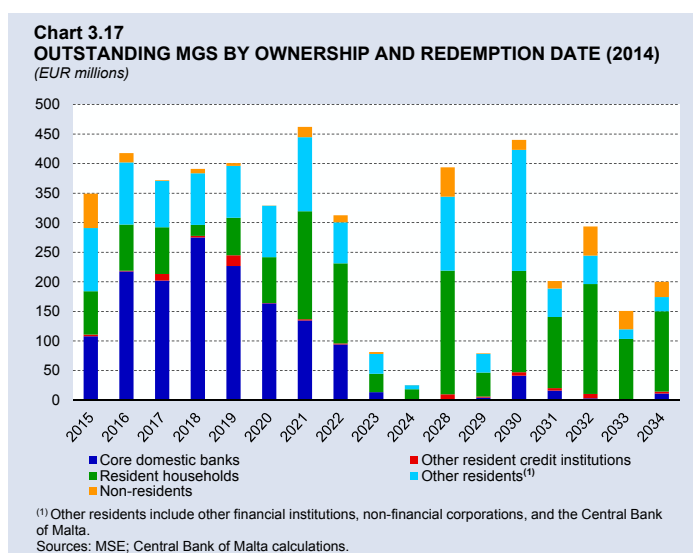
3.2.3 Domestic government paper

During 2014 holdings of domestic government paper by core domestic banks contracted by half a percent to €1.7 billion. Reduced holdings of Treasury bills marginally outweighed their increase in holdings of Malta Government Stock (MGS). As a result, holdings of domestic government paper as a proportion of total assets dropped by 1.3 percentage points to 10.3%. As a proportion of the securities portfolio, such holdings accounted for 37.3% in 2014, down by 10.9 percentage points over the previous year, in view of higher foreign securities holdings, which underpinned the expansion in total securities.

The majority of MGS remained redeemable in the short to medium term, with around €380 million in outstanding bonds redeemable each year until 2022 (see Chart 3.17). Furthermore, almost a third of total outstanding MGS were held by core domestic banks.

During 2014 the average maturity of all outstanding MGS has been extended, with new issuance of bonds maturing in 2033/4.¹¹ Meanwhile, funding costs for newly-issued MGS dropped significantly, as evidenced by the ten-year MGS yield, which by the end of 2014 dropped to 1.9%, down from 3.2% in December 2013. As a result, rollover risks for MGS remain remote. This is supported by the bid-to-cover ratio, which increased further in 2014 to 2.9, indicating a higher appetite for MGS by investors.

Although the participation of non-resident financial investors in the MGS market increased in 2014, it still remained somewhat limited at 6.3% of total outstanding MGS. Investors, including core domestic banks, retained their buy-to-hold



¹¹ In February 2015 the Treasury issued bonds redeemable in 2040.

approach. This is reflected in the average daily turnover in MGS of only €3.1 million, or 0.1% of the average outstanding MGS in 2014.

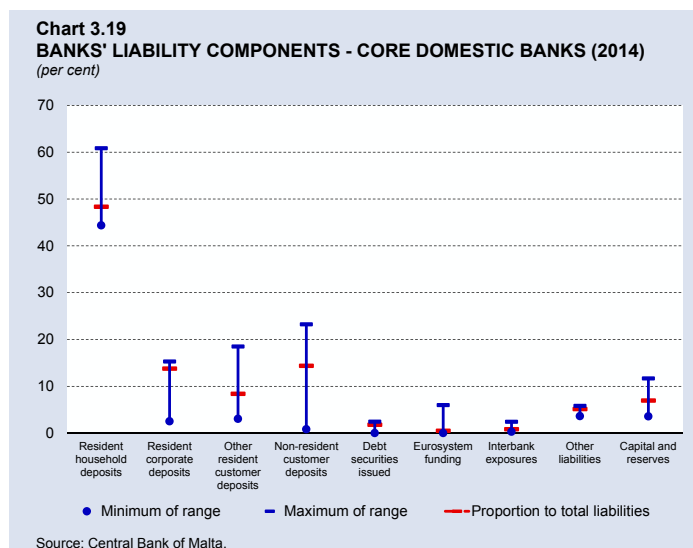
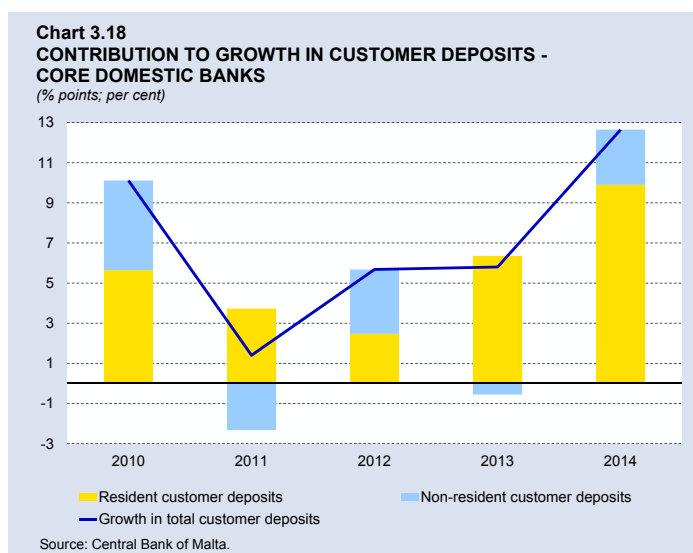
3.3 Funding

3.3.1 Customer deposits

In 2014 customer deposits with core domestic banks rose by 12.7% – the highest growth rate since 2007 and 6.8 percentage points over 2013 (see Chart 3.18). Such deposits remained the main source of funding for core domestic banks, making up 84.8% of their total liabilities. The source behind this expansion was resident customer deposits, up by 11.8%, predominantly from households and, to a lower extent, from corporates and other residents.¹² The boost in resident customer deposits was mainly euro-denominated, which make up more than 90% of total resident customer deposits.

While resident customer deposits have historically shown largely stable trends, non-resident customer deposits continued to show high volatility patterns. The drop of 3.1% in non-resident customer deposits reported in 2013 was entirely reversed, with such deposits increasing by 16.9% in 2014. However, such volatility patterns are not deemed to pose any funding risks on core domestic banks, given the banks' ample liquidity levels and considering that non-resident customer deposits accounted for less than 17% of total customer deposits, or 14.4% of total liabilities (refer to Section 4.4). Almost 58% of non-resident customer deposits were denominated in euro, with USD accounting for an additional one-fourth of non-resident customer deposits, followed by GBP, which represented around 10% of non-resident customer deposits.

Resident household deposits continued their upward trend, increasing by 7.8% in 2014 or 1.9 percentage points faster than the growth rate in the preceding year. These deposits accounted for 57.0% of total customer deposits held by core domestic banks, equivalent to 48.3% of liabilities (see Chart 3.19). Meanwhile, resident corporate deposits, which represent 16.2% of



¹² Other resident customer deposits include government and non-banking financial deposits.

total customer deposits, rose markedly in 2014, accelerating by 13.7%. This category accounts for 13.8% of total liabilities.

The acceleration in customer deposits was reported during periods of record low interest rates. Indeed, the funding costs for core domestic banks have generally dropped as indicated by the weighted average interest rates offered on euro-denominated resident deposits, which declined from 1.16% in 2013 to 0.81% in 2014. In a similar manner, the weighted average interest rates on foreign currency resident deposits declined from 0.36% to 0.29% during the period under review.¹³ Furthermore, such developments were observed in a year when deposit rates offered by non-core domestic banks remained relatively high. Indeed, non-core domestic banks collectively reported greater growth rates in customer deposits than core domestic banks. However, in terms of volumes, customer deposits are substantially larger in core domestic banks.

The maturity deposit structure shifted towards a greater preference to overnight deposits, with the share of current and savings accounts increasing by 7.7 percentage points to 64.7% of total deposits in 2014. In contrast, the share of term deposits with a maturity of less than one year decreased to 28.7% from 36.0% of total deposits in 2013. The largest drop stemmed from term deposits with a maturity of up to three months. Likewise, during the year the proportion of longer-term deposits, that is with a term to maturity of over one year, declined marginally by 0.4 percentage point to 6.6% of total deposits, as preference shifted further towards the very short-term end of the liquidity spectrum, given the relatively low rewards of locking in funds in longer-term deposits. This could also have been triggered by depositors' anticipation of better investment opportunities in the foreseeable future.

3.3.2 Eurosystem and other wholesale funding

Following the launch of the Targeted Longer-Term Refinancing Operations in September 2014, Eurosystem funding for core domestic banks increased by 10.4% but accounted for just 0.5% of core domestic banks' total liabilities by the end of the year. Furthermore, only 18.5% of their Eurosystem's eligible collateral had been utilised. Meanwhile, interbank funding rose by 81.4%, representing higher deposits with unrelated entities and, to a lesser extent, intragroup funding. Despite such a nominally large increase, interbank funding covered only 0.8% (2013: 0.5%) of total liabilities. Since 2012, debt securities issued by core domestic banks have remained stable, representing 1.8% of the banks' balance sheet value.

¹³ Resident deposits denominated in foreign currency account for 15.1% of total resident deposits.

4. CORE DOMESTIC BANKS: ASSESSMENT OF PERFORMANCE AND RESILIENCE

On the back of financial conditions and key challenges identified in Chapter 3, this Chapter assesses the performance of core domestic banks and tests their resilience. Section 4.1 describes developments in banks' balance sheets, while Section 4.2 analyses their financial performance. This is followed by developments in provisioning and coverage ratios in Section 4.3. Section 4.4 describes banks' liquidity conditions, whereas Section 4.5 assesses the adequacy of banks' shock absorption capacities. The latter is complemented by a set of stress tests, presented in Section 4.6.

In 2014 the decelerating trend in the growth of total assets observed in previous years was reversed, driven by larger loans and securities portfolios. Meanwhile, the liabilities structure remained stable, mainly reliant on short-term retail customer deposits. Profits remained strong despite an overall decline resulting from higher impairment charges and operational expenses. Also, net interest income decreased, albeit by a limited extent. Core domestic banks continued to augment their provisions, contributing to higher and improved coverage ratios. During the year these banks operated with healthy liquidity levels and met regulatory capital requirements. The overall shock-absorbing capacity of core domestic banks remained robust, as indicated by the stress tests.

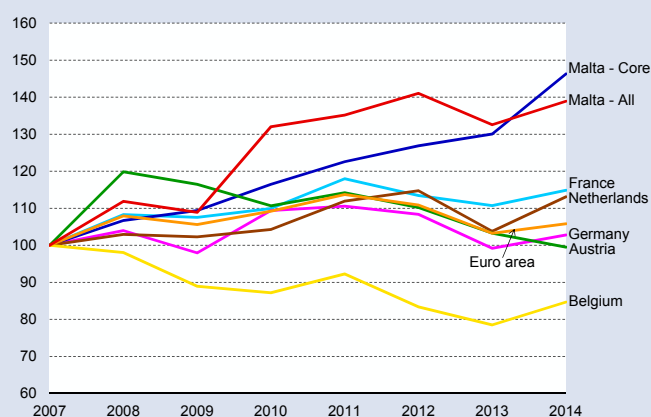
4.1 Balance sheet developments

In contrast to the contraction in the previous year, assets of the total Maltese banking sector grew by 4.8% in 2014. By way of comparison, in the euro area total bank assets expanded by 2.5%, partly reversing the contraction reported in 2013 (see Chart 4.1).

After four years of decelerating growth, assets of core domestic banks expanded by 12.5% in 2014. This increase was accompanied by shifts in the composition of banks' balance sheets.

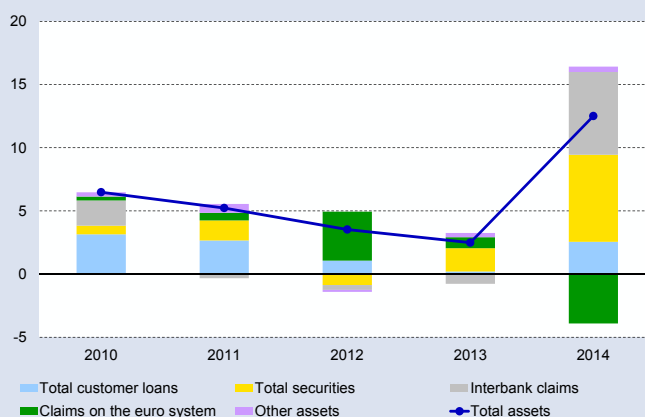
The expansion in balance sheet assets of core domestic banks was mainly in the form of securities holdings, which rose by 28.6% in 2014 to reach €4.7 billion, equivalent to 27.5% of total assets (see Chart 4.2). Interbank claims, largely with foreign credit institutions, also rose significantly, almost doubling in size to €2.0 billion and representing 11.7% of total assets. Interbank claims increased following the ECB rate cuts in June 2014, pushing the overnight deposit facility rate into negative territory. This encouraged core domestic banks to shift their placements from the Central Bank

Chart 4.1
GROWTH IN TOTAL ASSETS OF MONETARY FINANCIAL INSTITUTIONS - SELECTED EURO AREA COUNTRIES
(2007 = 100)



Sources: ECB; Central Bank of Malta.

Chart 4.2
CONTRIBUTION TO BALANCE SHEET GROWTH - CORE DOMESTIC BANKS
(percentage points)



Source: Central Bank of Malta.

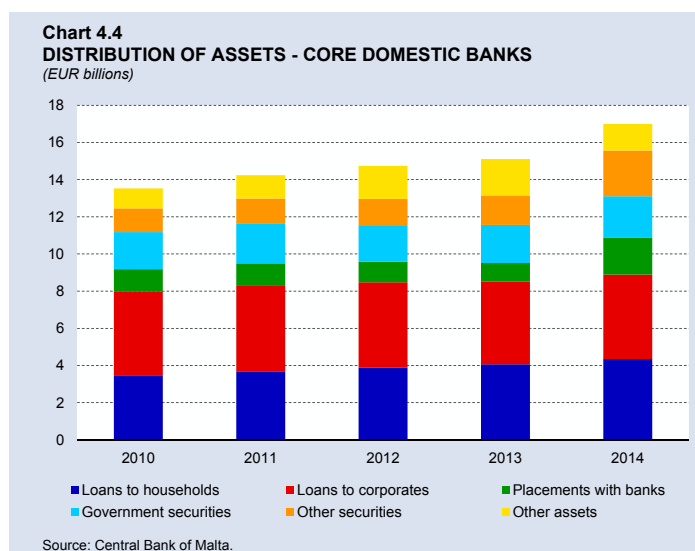
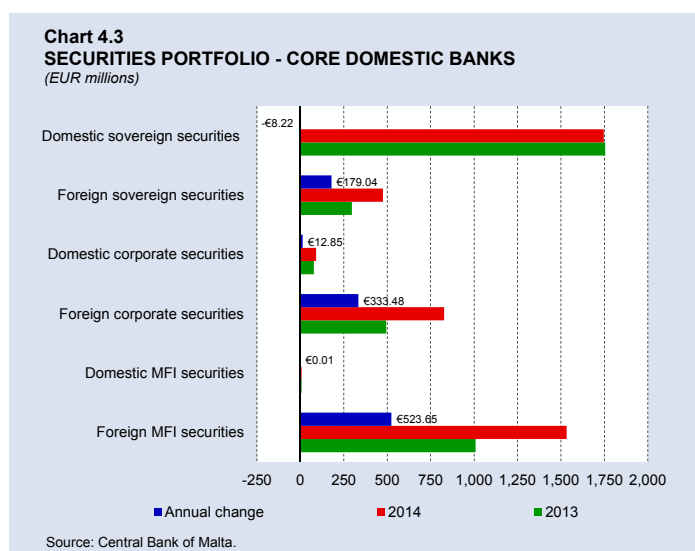
of Malta to other financial institutions, in view of more competitive rates. As a result, placements with the Central Bank of Malta contracted by 57.7% to account for just 2.5% of total assets. Customer loans rose by 4.5% during 2014.

The expansion in the securities portfolio mainly reflected higher holdings of securities of foreign monetary financial institutions, up by 51.9% to €1.5 billion (see Chart 4.3). These represented almost a third of the core domestic banks' securities portfolio. Holdings of foreign corporate securities rose by 67.5% to €827.4 million, while foreign sovereign securities increased by 60.4% to reach €475.4 million. Domestic corporate securities went up by 16.5% to €90.6 million and continued to represent a small share – of 1.9% – in the overall securities portfolio. Meanwhile, holdings of domestic government bonds decreased marginally, but continued to represent the largest investment item in the securities portfolio, equivalent to 37.3% of the total.

The domestic core banks' preference to hold securities until maturity was sustained, with securities booked as "held to maturity" increasing further and climbing by 6.9 percentage points to 52.6% of the total portfolio. Meanwhile, securities classified as "available for sale" accounted for 39.7% of the overall holdings, representing a drop of 4.4 percentage points over the previous year. Similarly, the proportion of securities "designated at inception at fair value through profit and loss" contracted by 2.4 percentage points to 7.2% of the total. Securities held for trading purposes remained marginal, representing 0.5% of the total portfolio.

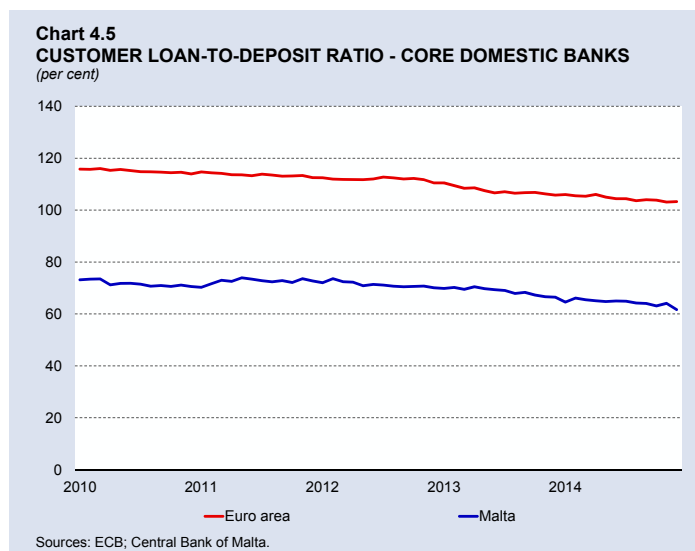
In 2014 the loan portfolio reached €8.9 billion (up by 4.5%), remaining the largest asset component for core domestic banks, equivalent to 52.3% of total assets. However, with the significant increase in securities holdings and interbank loans, the share of loans in total assets dropped by 4 percentage points compared with 2013 (see Chart 4.4).

On the liabilities side, customer deposits went up further by 12.7% (see Chart 3.18). These accounted for 84.8% of core domestic banks' liabilities. The faster growth in customer deposits in relation to customer loans (4.5%) pushed down the customer loan-to-deposit ratio by a further 4.8 percentage points, reaching



61.7% by end-2014 (see Chart 4.5). As observed in previous years, this ratio is substantially lower than the euro area average of 103.2%. The gap reflects the significance of retail funding to core domestic banks when compared with euro area banks.

After customer deposits, the next largest liability component consisted of shareholders' funds, which accounted for 7.0% of total liabilities. The remaining liabilities include interbank and Eurosystem funding, amongst other liabilities, which, however, constitute a low proportion in total liabilities (refer to Section 3.3.2).



BOX 3: CATEGORISATION OF BANKS ACCORDING TO SYSTEMIC RELEVANCE

In the 2011 edition of the Financial Stability Report (FSR), the Central Bank of Malta published the methodology used to categorise banks in terms of systemic relevance.¹ The methodology is based on five broad criteria reflecting size, substitutability and connectivity; weights were then assigned to each criterion as follows:

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

On the basis of this methodology, three categories were identified, each with a different level of systemic relevance, namely, core domestic banks, non-core domestic banks and international banks.

The Central Bank of Malta decided that this exercise shall be conducted every two years to ensure that each bank's standing in its relevant category shall remain valid. If deemed necessary, the exercise may be conducted earlier to ascertain that any developments in the banking sector's landscape and ancillary related systemic implications are captured in a timely manner. The exercise was undertaken for the 2013 edition of the FSR, in which FCM Bank Limited was reclassified from international bank to non-core domestic bank.

In January 2015 the Central Bank of Malta carried out the exercise once more, using end-2014 data. Results reaffirmed that the current five core domestic banks remain the most systemically-relevant credit institutions in Malta. Furthermore, this indicator-based methodology revealed that

¹ For a detailed explanation of the methodology adopted refer to the Special Feature in the 2011 FSR, p. 47.

Table 1
SIZE AND LIST OF BANKS UNDER EACH CATEGORY

Core domestic banks	Non-core domestic banks	International Banks
APS Bank Limited	BAWAG Malta Bank Limited	AgriBank plc
Banif Bank (Malta) plc	FCM Bank Limited	Akbank T.A.S
Bank of Valletta plc	FIMBank plc	CommBank Europe Limited
HSBC Bank Malta plc	IIG Bank (Malta) Limited	Credit Europe Bank NV
Lombard Bank Malta plc	Izola Bank plc	Deutsche Bank (Malta) Limited
Mediterranean Bank plc	Sparkasse Bank Malta plc	ECCM Bank plc
Mediterranean Corporate Bank Limited*		Ferratum Bank plc
		NBG Bank Malta Limited
		Nemea Bank Limited
		Novum Bank Limited
		Pilatus Bank Limited
		Turkiye Garanti Bankasi A S
Total assets (EUR millions) [December 2014]		
19,962.4	2,208.9	30,341.4
Total assets (as % of GDP) [December 2014]		
250.7	27.7	381.1

* as a subsidiary of Mediterranean Bank plc

Mediterranean Bank plc has further increased its domestic relevance, mainly through targeting resident deposits, higher holdings of domestic securities, and through the takeover of Volksbank Malta Limited, re-branded as Mediterranean Corporate Bank Limited, in 2014. As a result of this development, this group has further raised its presence locally through higher lending to residents.² In this regard, the Central Bank of Malta's Financial Stability Committee agreed that this banking group, at sub-consolidated level, will be considered as a core domestic bank as from the next *Financial Stability Report Update 2015*, which will cover developments in the financial system during the first half of 2015.

Furthermore, the exercise also showed that Credit Europe Bank N.V., which was previously classified as a non-core domestic bank, will now be reclassified as an international bank. This change in categorisation was driven by a declining trend in its resident deposits over recent years, resulting in negligible links with the domestic economy.

Table 2
MAIN FINANCIAL STABILITY INDICATORS

December 2014 (%)	Core domestic banks		Non-core domestic banks		International banks	
	Prior to reclassification	Post reclassification	Prior to reclassification	Post reclassification	Prior to reclassification	Post reclassification
Capital adequacy ratio	14.1	14.7	18.6	18.5	70.0	70.0
Tier 1 capital ratio	10.5	10.9	15.5	17.7	70.0	70.0
Liquid assets to short-term liabilities	49.0	50.4	82.1	77.9	85.1	85.1
Customer loan-to-deposit ratio	61.7	64.0	135.0	75.7	77.1	93.0
NPL ratio	9.3	9.0	5.1	7.4	1.4	1.4
Coverage ratio	44.1	43.3	52.1	78.6	53.3	45.4
Return on equity	15.4	14.9	-0.2	-3.2	2.9	2.5
Return on assets	1.1	1.1	-0.3	-1.3	1.0	0.9

Source: Central Bank of Malta.

² For the benefit of this exercise, the word "group" refers to the banking group at sub-consolidated level, which includes Mediterranean Bank plc and Mediterranean Corporate Bank Limited.

These decisions were subsequently endorsed by the Joint Financial Stability Board on 27 February 2015. As a result of these reclassifications, the banks currently operating in Malta will be classified as shown in Table 1 as from 2015.

Table 2 shows the main financial soundness indicators of the banks prior and post-reclassification as at December 2014. As indicated, these are not expected to change significantly with the introduction of the Mediterranean Banking Group as a core domestic bank. With regard to the non-core domestic and international banks, given the size of Mediterranean Bank plc and to some extent Credit Europe Bank N.V., one could note significant changes in some indicators as a result of the reclassification.

4.2 Profitability

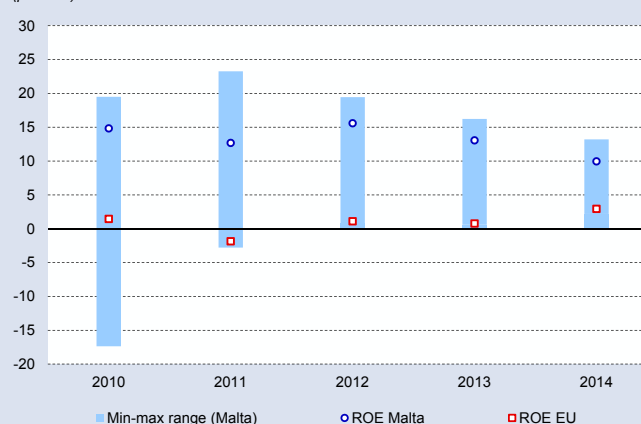
In 2014 the profitability of core domestic banks remained healthy despite a drop of 17.0% in pre-tax profits over the previous year. After-tax profit decreased by 18.4% during the period under review. This led to some weakening in the profitability indicators when compared with their historical averages, with the return on equity (ROE) easing by 3.1 percentage points to 10.0% in 2014, whereas the return on assets (ROA) narrowed to 0.7%, 0.2 percentage point lower than in 2013 (see Charts 4.6 and 4.7).¹ The heterogeneity in the profitability ratios across banks, meanwhile, diminished further. Although decreasing, on average profitability ratios of core domestic banks remained healthier than those of small EU banks. The ROE and ROA of EU banks stood at 2.9% and 0.2%, respectively in 2014, showing some improvement on a year earlier.

The drop in pre-tax profits resulted mainly from higher non-interest expenses, as otherwise total income declined only marginally (see Table 4.1). Non-interest expenditure increased by 13.5%, to €292.2 million, on account of higher operating expenses (including staff expenditure), as well as impairment charges.² The latter increased by

¹ The ROE and ROA are worked out with profit after-tax figures.

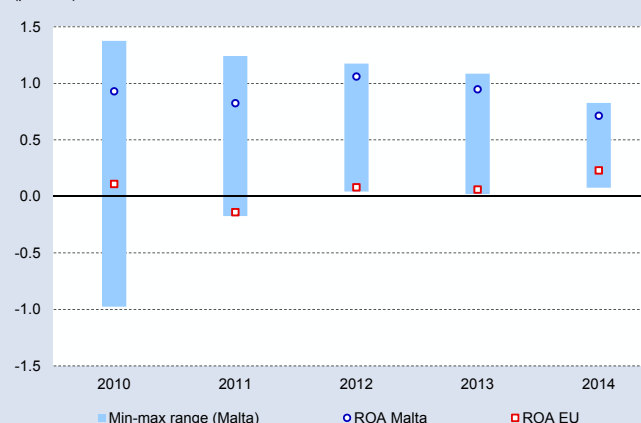
² Impairment charges include write-offs and provision charges net of recoveries and write-backs.

Chart 4.6
RETURN ON EQUITY - CORE DOMESTIC BANKS
(per cent)



Note: EU data refers to small EU banks. In the case of ROE EU, 2014 refers to June.
Sources: ECB; Central Bank of Malta.

Chart 4.7
RETURN ON ASSETS - CORE DOMESTIC BANKS
(per cent)



Note: EU data refers to small EU banks. In the case of ROA EU, 2014 refers to June.
Sources: ECB; Central Bank of Malta.

Table 4.1
MAIN COMPONENTS OF THE PROFIT AND LOSS ACCOUNT

EUR millions

	2010	2011	2012	2013	2014
Total net interest income	292,916	314,414	328,679	306,341	302,915
Net interest income on intermediation	206,759	223,487	237,601	231,359	225,587
Other net interest income	86,157	90,927	91,078	74,982	77,328
Non-interest income	121,619	119,479	163,328	164,041	166,052
Trading profits ¹	1,647	-27,770	21,573	15,301	8,938
Other non-interest income	119,972	147,248	141,755	148,741	157,115
Non-interest expense	(227,438)	(260,032)	(258,481)	(257,353)	(292,194)
Net profit before tax	187,097	173,861	233,527	213,030	176,773
Net profit after tax	123,913	113,313	152,367	139,971	114,188

¹ Trading profits consist of fair valuation movements and gains or losses on traded securities.

63.0% to €51.4 million, partly because of greater provision charges, owing to increased provisioning for past loans reflecting more rigorous provisioning policies. Furthermore, the largest core domestic banks incurred additional compliance and regulatory costs arising from the ECB's Comprehensive Assessment exercise. As a result of higher overall costs, the proportion of non-interest expense in gross income grew by 7.6 percentage points to 62.3% in 2014.

While interest income remained the main contributor to profits, banks reported a drop of 1.1% (€3.4 million) in net interest income in 2014. This fall resulted from lower net interest income from intermediation, down by €5.8 million. Lower interest income was, however, partly offset by a reduction in interest expense. These developments reflect trends in interest rates, when conventional monetary policy was eased on two occasions by the ECB during the year. Furthermore, the rise in deposits exceeded the increase in loans, exerting downward pressure on net interest income. This was alleviated as deposits remained predominantly short term, thus attracting a lower rate of interest. The "other" net interest income category, which mainly reflects dividends, rose by €2.3 million or 3.1%. This partly reflected an expanded securities portfolio.

Non-interest income, which accounted for the remainder of gross income, rose by 1.2% (€2.0 million) during 2014. Fees and commissions, which comprise almost 19% of gross income, went up by 4.6% to €88.4 million. However, trading profits declined as a result of lower fair value gains.

Despite some weakening in the financial performance of core domestic banks, their traditional business model, including the reliance on customer deposits as the main funding source, continues to support positive returns. Looking forward, pressures on profits from the international environment are expected to persist, particularly due to the low interest rate regime. However, the domestic pick-up in loan growth and the tapering off of non-performing loans (NPL) may alleviate somewhat these pressures.

4.3 Loan loss provisions

In 2014 core domestic banks augmented their loan loss provisions by over a fifth, equivalent to €36.0 million. This was mainly reflected in higher specific provisions, which rose by €29.0 million or 27.6%, reflecting adoption of more rigorous provisioning policies. Interest in suspense on NPLs grew by 15.5% in 2014. In this regard, the coverage ratio based on specific provisions and interest in suspense improved by 4.2 percentage points to 34.7% in 2014, largely owing to higher provisioning for corporate sector loans.

At the same time, collective provisioning by core domestic banks rose by 9.8% in 2014. The faster growth rate in total provisions (collective, specific provisions and interest in suspense) rather than in NPLs pushed up the core domestic banks' coverage ratio by 4.5 percentage points to 44.1% – the highest level in eight years.³

Following the implementation of the revised Banking Rule 09/2013 on credit risk at the end of 2013, banks implemented the second allotment to the “Reserve for General Banking Risks” in 2014. The total amount of reserves set aside by core domestic banks to complement their credit

risk mitigation practices equalled 70.0% of the regulatory allocation and amounted to €15.6 million.⁴ Once these reserves are taken into consideration, the coverage ratio of core domestic banks improved by a further 1.9 percentage points to 46.0% (see Chart 4.8).

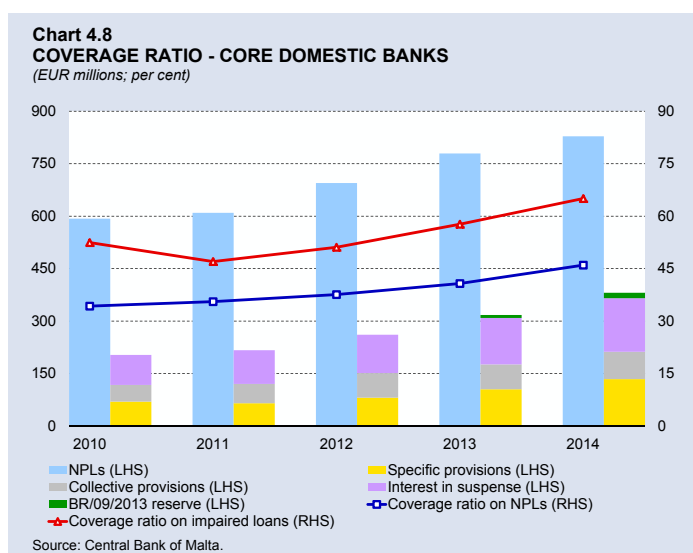
The coverage ratio based on impaired loans as per International Financial Reporting Standards increased from 51.3% to 56.6%.

During the year the proportion of collateral to NPLs declined by 5.7 percentage points to 64.9%.⁵ In total of collateral, specific provisions, interest in suspense and the BR/09/2013 reserve amount to 101.5% of core domestic banks' NPLs. This proportion declined by 0.8 percentage point when compared with 2013. This coverage ranges from a low of 95.7% to a high of 114.3% across individual banks. Coverage of NPLs strengthens further to 110.9% if collective provisions are included in the computation.

The Survey on Mortgage and Commercial Property Lending Practices conducted by the Central Bank of Malta indicated that the valuation haircut practices across core domestic banks averages at around 15% for residential property-backed loans and around 29% for commercial property-backed loans. In addition, the residential and commercial loan-to-value ratios as at the end of 2014 stood at around 74% and 69%, respectively.

4.4 Liquidity

Throughout 2014 core domestic banks were characterised by ample liquidity and supported by stable funding sources. As at the end of 2014, the liquidity ratio of this group of banks stood unchanged at 49.0%, as both liquid assets and short-term liabilities rose proportionately by almost 20%. This ratio continued to stand comfortably above the minimum regulatory requirement of 30% (see Chart 4.9).⁶ During the year the heterogeneity in individual banks' ratios narrowed compared with previous years. The ratios ranged between 44.3% and 72.5%, with the lowest ratio across banks improving further.



³ The coverage ratio is defined as the ratio of total provisions and interest in suspense to total NPLs.

⁴ BR09/2013 “Measures Addressing Credit Risks Arising from the Assessment of the Quality of Asset Portfolios of Credit Institutions Authorised under the Banking Act 1994”.

⁵ All collateral, including property-backed collateral, is included in this ratio. In the case of immovable property pledged as collateral, banks apply significant haircuts, often in the region of 20% to 30%.

⁶ The liquidity ratio is defined as liquid assets to short-term liabilities. Refer to Banking Rule 05/2007: Liquidity Requirements of Credit Institutions authorised under the Banking Act 1994.

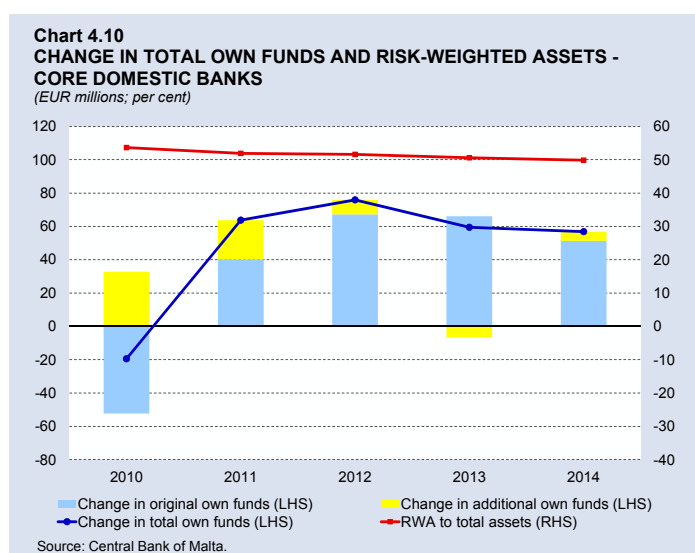
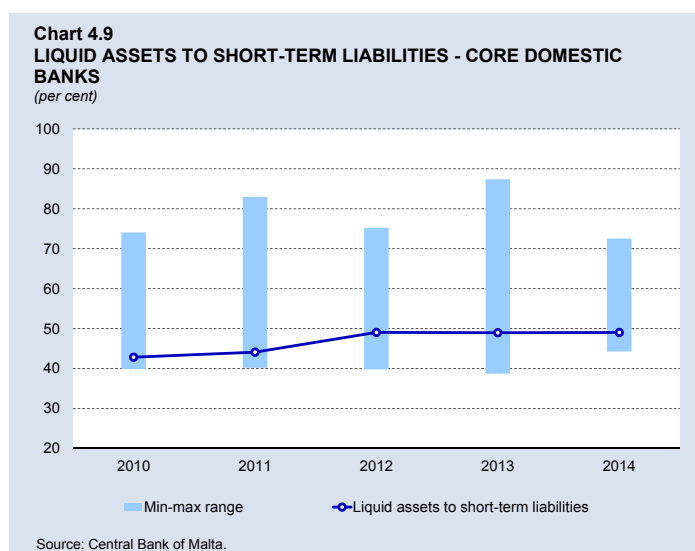
In terms of liquidity, the composition of liquid assets remained of high quality, consisting predominantly of marketable debt securities. These accounted for around 61% of total liquid assets, up by 4.7 percentage points compared with 2013. Similarly, balances held with credit institutions increased to 29.8% of liquid assets, up from 17.8% in 2013, whereas the balances held with the Central Bank of Malta fell by 61.1% to account for only 6.5% of liquid assets, after the main refinancing operation rate cuts announced by the ECB (refer to Section 4.1).

In terms of maturity, deposits with core domestic banks remained skewed towards the short term, with the share of current and savings accounts rising to 64.7% of total deposits up from 57% in 2013 (see Section 3.3.1).

Banks' liquidity conditions are regulated by the Capital Requirements Directive IV (CRD IV) and the Capital Requirements Regulation (CRR) framework, which introduced two new liquidity measures: the Net Stable Funding Ratio (NSFR) and the Liquidity Coverage Ratio (LCR). The latter will be phased in gradually, rising from 60.0% as from October 2015 to 100.0% by 1 January 2018. The LCR ensures that a bank holds sufficient liquid assets to meet its net liquidity outflows during a 30-day stress period.⁷ Based on an assessment exercise using December 2014 data, participating core domestic banks already meet the new regulatory threshold established by the new framework.⁸ The implementation of the NSFR, however, is foreseen for 2018 although discussions about its implementation have not been as yet concluded. The NSFR ensures that banks achieve a "stable funding profile" by limiting their excessive reliance on short-term wholesale funding relative to the liquidity risk characteristics of their assets and off-balance-sheet exposures.

4.5 Capital and leverage

In 2014 the capital position of core domestic banks remained healthy with the Capital Adequacy Ratio (CAR) standing at 14.1%, albeit down from 14.9% in 2013, but well above the 8.0% regulatory threshold.⁹ The drop in CAR occurred owing to a higher increase in risk-weighted assets (RWA) with respect to the rise in total own funds.¹⁰ In particular, RWA rose by €835.2 million or 10.9% on account of higher lending to the corporate



⁷ Source: European Commission.

⁸ This is based on information obtained from participant banks in the Bank for International Settlements' Quantitative Impact Study.

⁹ The capital ratios are based on the Banking Rule 04/2013.

¹⁰ Core domestic banks follow the "standardised approach" for capital adequacy, thus the calculation of RWAs is based on pre-set weighting for various asset classes.

sector, which carries higher risk weights (see Chapter 3.1.1). Total own funds went up by €56.8 million or 5.0% (see Chart 4.10). Despite the increase in RWA, the banks' credit risk profile, as measured by the RWA to total assets ratio, dropped by a further 0.7 percentage point to 49.9%.

The fall in additional own funds reported in 2013 was almost completely reversed in 2014 when this capital increased by 1.9%. Meanwhile, the rise in original own funds was more contained compared with 2013, up by 6.1% (2013: 8.5%). This was augmented through higher retained earnings, which were

partly converted through a bonus issue into ordinary shares. The latter are considered as the better quality and most permanent type of capital. The faster growth in RWA led to a fall in Tier 1 (T1) capital ratio, down by 0.5 percentage point to 10.5% (see Chart 4.11). Core domestic banks, however, reported a wider disparity in 2014 as the highest level of the T1 capital ratio increased to 18.7% while the lowest level stood at 6.4%, marginally higher than the end-2013 ratio.

The CRD IV/CRR came into force in January 2014. Based on the new regulatory framework, the total capital ratio stood at 13.8%, higher than the regulatory requirement of 8.0%. The Common Equity Tier 1 (CET1) ratio and T1 capital ratio both stood at 11.3%, higher than the required minimum of 4.5% and 6%, respectively.¹¹

The leverage ratio, which is defined as capital and reserves over total assets, dropped by 0.3 percentage point to 7.0%. This decline resulted from a pick-up in asset expansion, up by 12.5% in 2014, which exceeded the 8.2% increase in capital and reserves. The range of the leverage ratio stood between 3.6% and 11.7% across individual banks, narrowing somewhat, given that the highest ratio declined from 12.7% in 2013.

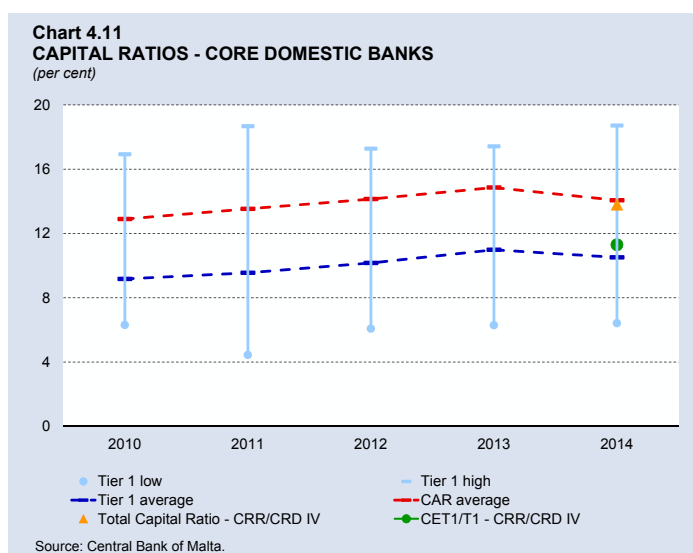
4.6 Stress tests

As part of its role in ensuring financial stability, the Central Bank of Malta carries out a range of stress testing exercises to analyse the resilience of the domestic financial system to extreme, yet plausible, shocks. The stress tests presented broadly capture the elements of credit risk, sovereign risk, liquidity risk and market risk. More specifically, the tests are based on the following four scenarios:

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

The risk outlook remains the same as in the previous *Financial Stability Report*, namely that the probability of the first three scenarios occurring continues to be low, whereas the likelihood of a deposit run materialising is deemed remote. Results should be considered as indicative in view of their univariate nature, which excludes possible effect of simultaneous shocks and second-round effects by construction.

¹¹ These ratios are not comparable with ratios presented in previous *Financial Stability Reports*.

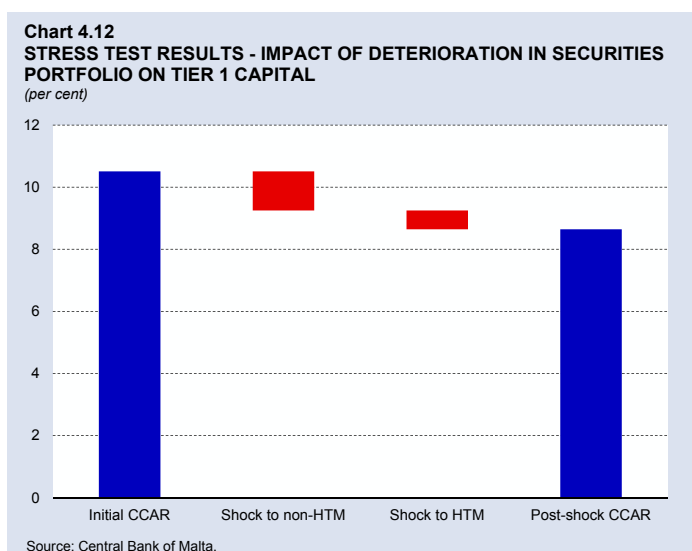


Scenario 1: Credit quality deterioration in the securities portfolio

The stress test assesses the impact of an increase in the market price of credit risk, commensurate with the increase in the ITRAXX index between April 2011 and September 2011 in the case of marked-to-market securities.¹² For securities that are held to maturity, a three-notch downgrade in their respective credit rating is applied. The latter translates into higher probabilities of default. The resulting losses are charged directly to capital, while risk weighted assets are assumed to remain constant.

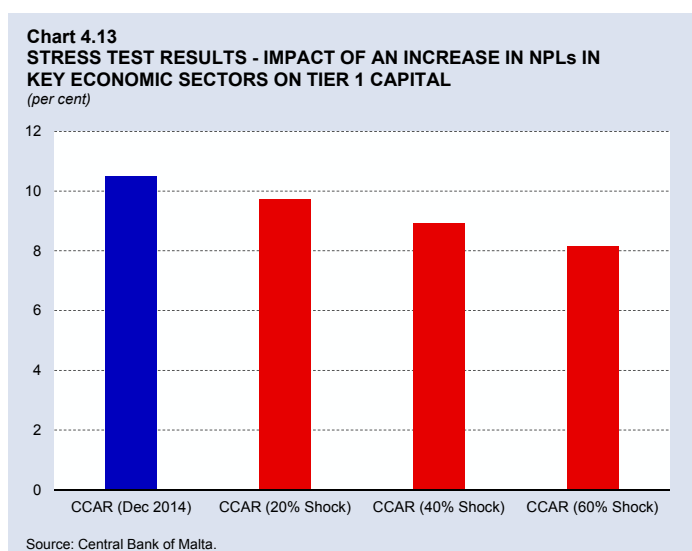
The average credit grade of the core banks' securities portfolio as at end-2014 stood at A, with very little exposure to the more speculative classes. The rating grades were based on a composite index estimated on the basis of the second best of Fitch, Moody's and Standard & Poor's credit ratings. Over half of the portfolio was invested in sovereign bonds, with the larger portion being Malta Government Stocks. Investments in financial corporate paper constituted the bulk of the remaining bonds.

The assumed increase in the market price of credit risk and the assumed three-notch downgrade in credit ratings leave core banks in a comfortable position as the Core Capital Adequacy Ratio (CCAR) drops by 185bps from 10.51% to 8.64% (see Chart 4.12).



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

This second scenario assumes that following an adverse macroeconomic shock, NPLs increase by 20% to 60% in selected key economic sectors, namely household, manufacturing, construction and real estate, wholesale and retail trade, transport and accommodation sectors. The level of loan loss provisions is expected to increase proportionately in line with the uncollateralised portion of the rise in NPLs, leading to a drop in profits and consequently, lower capital. Furthermore, the banks' capital ratio is also negatively influenced by the higher risk weights associated with NPLs.



¹² Between April 2011 and September 2011 the ITRAXX index recorded the longest upward uncorrected trend.

The results reveal that, even under the most extreme scenario (i.e. a 60% increase in NPLs in key economic sectors), the aggregate banks' CCAR remains comfortably above the regulatory threshold of 4.0%, standing at 8.2% (see Chart 4.13).

At a sectoral level, the main contributors to the fall in the CCAR remain the construction and real estate sectors, reflecting the larger share of NPLs reported in these sectors (see Chart 4.14).

Scenario 3: A drop in property prices

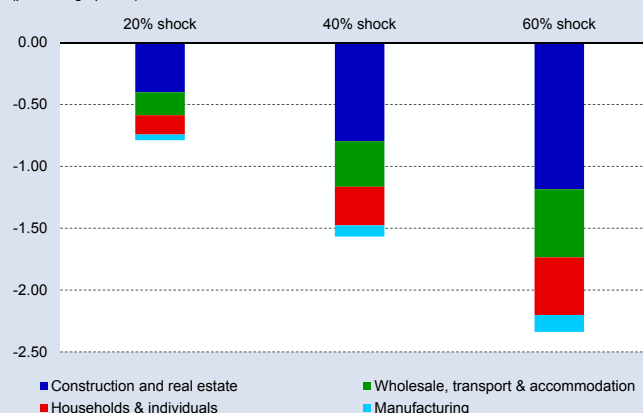
This scenario assumes a drop in property prices of 20% to 30%, which in turn is translated into lower loan collateral values.¹³ The assumed haircuts on collateral are applied on the already discounted extendible collateral values reported by banks.¹⁴ The test assumes that, as collateral values decline, loan loss provisions will be raised accordingly. Furthermore, this scenario is assumed to coincide with a significant increase in NPLs ranging from between 5% and 10%, arising from negative wealth effect. Additional NPLs lead to a further increase in provisions, equivalent to the uncollateralised part of the non-performing loans.

Under such a scenario the test results indicate that, on aggregate, banks would be able to comfortably withstand a combination of a 30% simulated drop in collateral values and a concurrent increase in NPLs of 10% (see Chart 4.15).

Scenario 4: Persistent deposit withdrawals

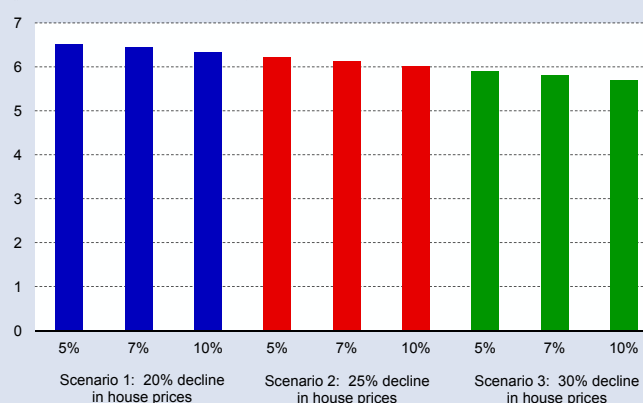
The liquidity sensitivity framework was revised to allow for the use of granular bank-specific bond holdings data, as well as bond-specific market information such as bid-ask spreads. The test is an implied cash flow model, which assesses assumed liquidity outflows in relation to the counter-balancing capacity of a bank. The latter is defined as the quantity of funds at the disposal of a financial institution, which can be used to meet liquidity requirements. In the test, the counter-balancing capacity is shocked to reproduce a scenario

Chart 4.14
STRESS TEST RESULTS - IMPACT OF AN INCREASE IN NPLs BY SECTOR ON TIER 1 CAPITAL
(percentage points)



Source: Central Bank of Malta.

Chart 4.15
STRESS TEST RESULTS - IMPACT OF A DROP IN HOUSE PRICES ON TIER 1 CAPITAL
(per cent, x axis = increase in NPLs)



Source: Central Bank of Malta.

¹³ Over 80% of the banks' collateral consists of immovable property.

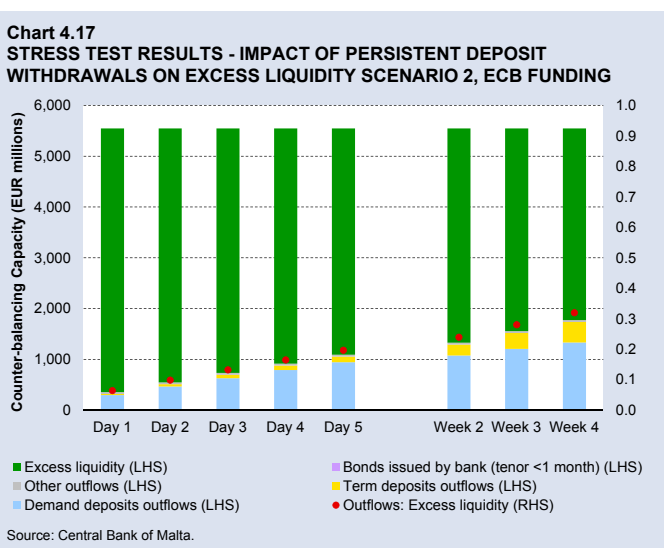
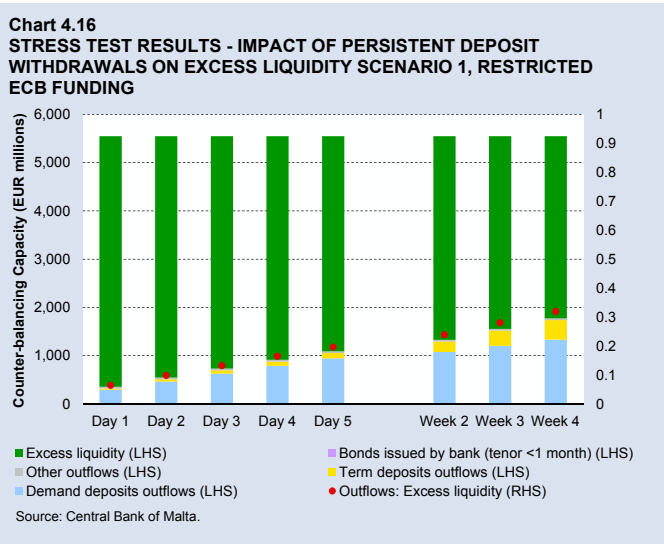
¹⁴ Extendible value of collateral differs from the market value of collateral. The former refers to the realisable value of collateral, which the credit institution expects to obtain under depressed forced sale circumstances – this is generally lower than the market value. Consequently, the test may be considered as rather extreme.

when a bank is forced to sell fair value securities to meet its deposit outflows at a time when liquidity on the exchange is thin. To this end, the counter-balancing capacity is calculated under two different conditions. In the first scenario, banks are allowed to obtain ECB funding only against securities that were pledged with the ECB as at reference date. The bank would have to sell the remaining bonds at fire-sale rates provided that these securities are not accounted as held to maturity. In the second scenario, the bank is allowed to pledge all ECB eligible assets held as at reference period and get ECB funding against these securities, subject to assumed valuation haircuts that would be implemented by the ECB. In this second scenario only non-eligible fair valued securities are sold on an exchange at fire-sale rates.

In terms of fire-sale rates, the liquidity haircut is a function of the bid-ask spread of the bond as at reference date, and issuer category of the bond, as well as its credit rating. The level of stress severity is oriented on past crisis events, the most prominent of which is the Lehmann Brothers collapse. Consideration is also given to the recent deposit withdrawals in Greece.

Chart 4.16 and Chart 4.17 represent the liquidity position of core banks under scenarios one and two. The bar chart plots on the left axis the liquidity outflows and the excess liquidity for the first five days followed by the subsequent three weeks. The total length of the bar represents the counter-balancing capacity, which is assumed to remain fixed. As the scenario proceeds in time, the liquidity outflows increase, and excess liquidity contracts. The system would be unable to withstand the shock if all liquid assets were absorbed. The chart also plots the ratio of outflows to excess liquidity, represented by a red dot, plotted on the right axis.

The results show that banks can survive the assumed stressed deposit outflows with relative ease, even when ECB funding is limited to the amount of pledged securities as at reference period. In scenario one, the value of the shocked counter-balancing capacity stands at €4.2 billion. The system-wide liquidity outflows, which were estimated at around €350 million on day 1, increase to €1.8 billion by the end-of-the-month survival period, contracting the excess liquidity in the process from €3.8 billion to €2.4 billion.¹⁵



¹⁵ The liquidity stress test draws on a 2012 IMF paper by Christian Schmieder, Heiko Hesse, Claus Puh, Benjamin Neudorfer and Stefan W. Schmitz entitled 'Next Generation System-Wide Liquidity Stress Testing' and recent IMF Financial Sector Assessment reports. The 2014 IMF publication 'A Guide to IMF Stress Testing, Methods and Models' edited by Ong LL, was also consulted.

In scenario two, when banks are able to obtain ECB funding against all eligible securities subject to relevant valuation haircuts, the shocked counter-balancing capacity is higher, standing at €5.5 billion. Deposit outflows remain the same as those calculated under scenario one. As a result the system is left with excess liquidity, which contracts from €5.1 billion to €3.7 billion.

5. THE OTHER COMPONENTS OF THE FINANCIAL SYSTEM

This Chapter presents an analysis of the other major components of the financial system. Non-core domestic banks and international banks are reviewed in Section 5.1, while insurance companies and investment funds are reviewed in Section 5.2.

Risks to financial stability emanating from these financial institutions have remained low. Both non-core domestic banks and international banks maintained weak linkages with the domestic economy, creating only a small and well contained risk of contagion with the financial system and the economy. The banks' overall performance was mainly affected by group restructuring decisions leading to downsizing of their foreign operations and, to a lesser extent, owing to higher impairment charges relating to bank-specific issues. With regard to the insurance and investment funds sectors, their linkages with core domestic banks were sustained. However, their performance remained satisfactorily governed by prudent practices.

5.1 Non-core and international banks

5.1.1 Non-core domestic banks

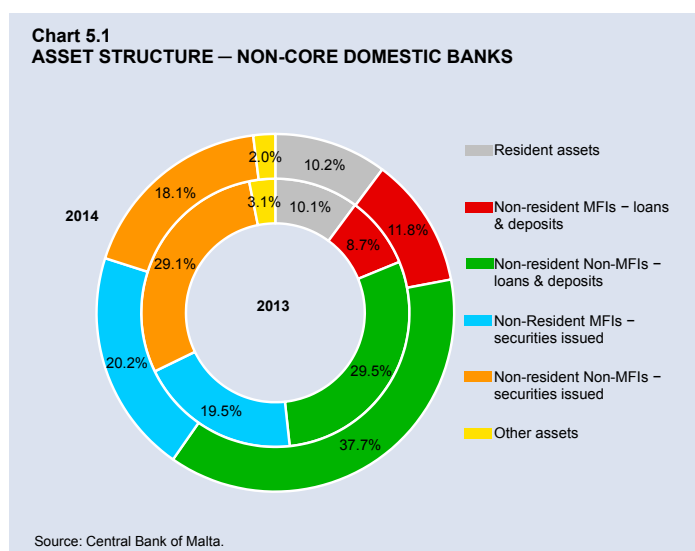
The nine banks in the list of domestic non-core banks remained unchanged during 2014. Owing to restructuring decisions at group level, two banks experienced a reduction in their capital position. During the year total assets of non-core domestic banks expanded further, reaching 77.0% of GDP. Their resident assets and liabilities made up 10.2% and 19.4%, respectively, of the total balance sheet size, so that their inter-linkages with the domestic economy remained low. Overall, these banks remained well capitalised, most of which were profitable and with little credit and liquidity risks.

Asset structure

As at the end of 2014, total assets of non-core domestic banks amounted to €6.1 billion, an increase of 15.6% over the previous year. This expansion was mainly driven by higher claims (loans and deposits) on non-monetary financial institutions (MFI) sectors. The share of these claims in total assets reached 37.7% (see Chart 5.1).¹ On the other hand, securities issued by non-MFIs declined by 11.0 percentage points, bringing their share in total assets to 18.1%.

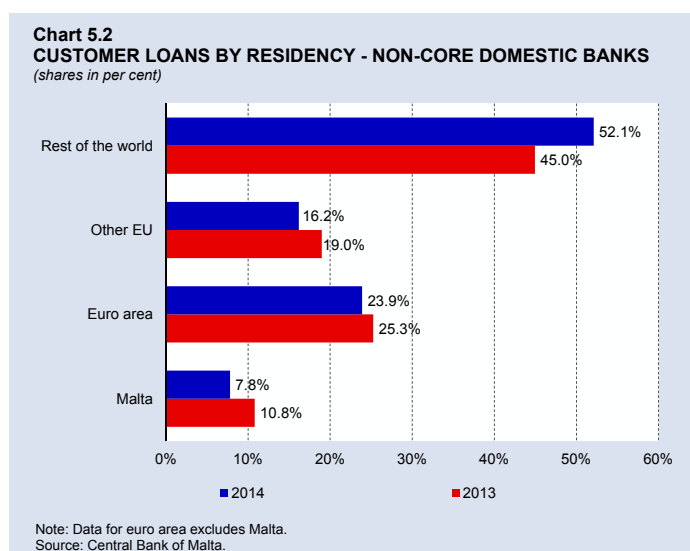
Lending and credit risk

During 2014 total lending of non-core domestic banks increased by 40.8% to €2.7 billion, mainly on account of customer loans, which expanded by 43.0%, reaching €2.5 billion. A total of €1.9 billion of these loans were related to non-resident corporates, whose borrowing from non-core domestic banks rose by 42.3%. Lending to real estate activities and manufacturing accounted for the largest increase in non-resident corporate lending. Meanwhile, non-core domestic banks reported a decline in household lending. At just €15.4 million, loans to households represented a minimal share of their overall loan portfolio.



¹ Non-MFI sector comprises general government, other financial intermediaries and financial auxiliaries, insurance corporations, pensions funds, corporates, and households.

In terms of residency, the increase in customer loans was mainly driven by higher lending to non-EU residents, which accounted for slightly over half of total customer loans (see Chart 5.2). Customer loans granted to euro area and other EU residents accounted for 23.9% and 16.2% of total customer loans, respectively, and both were marginally lower than in the previous year. Loans to customers resident in Malta grew by 3.3% during 2014. However, their share in the total declined from 10.8% in 2013 to 7.8% by the end of 2014, as loans to non-residents rose at a faster pace than the resident category. Indeed, lending to residents by non-core domestic banks continued to account for a relatively low proportion of all bank lending to Maltese residents, equivalent to 2.2%.

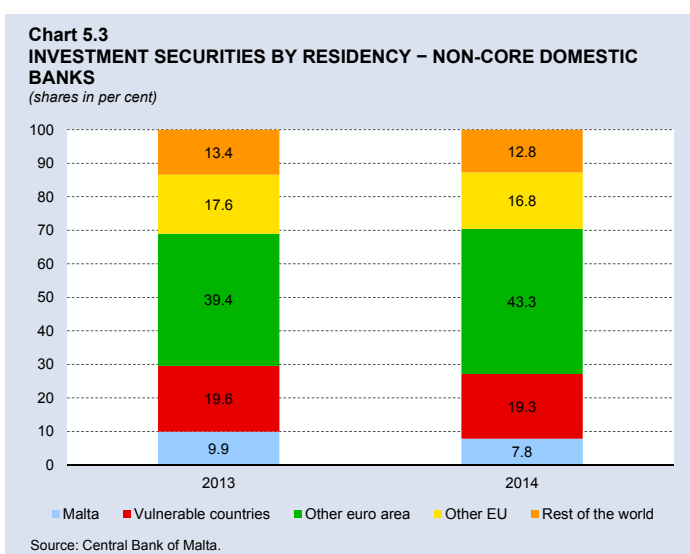


During 2014 the non-performing loan (NPL) ratio increased by 0.3 percentage point to 5.1% owing mainly to non-resident loans. The rise was largely driven by loans pertaining to the financial & insurance sector, and to a lesser extent, by the administrative & support services and manufacturing sectors. Conversely, NPLs related to the non-resident transportation & storage sector declined.

Meanwhile, resident NPLs, which account for around a third of the banks' total NPLs declined. The fall resulted mainly in the electricity, gas, steam & air conditioning supply sector, as well as in households. Furthermore, the coverage ratio increased by over 10 percentage points during the last year, reaching 52.1%, on account of higher specific provisions. On balance, overall credit risk remained contained.

Investment portfolio

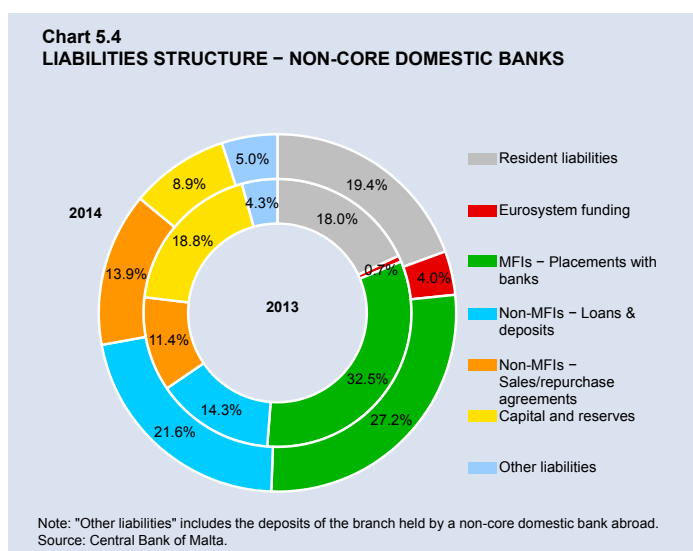
During the year holdings of securities went up by 5.7% to €2.4 billion, driven by higher holdings of securities issued by MFIs and sovereigns. In terms of residency, debt issued in euro area countries (excluding Malta and vulnerable euro area countries) rose by 16.0% in 2014, to make up 43.3% of total holdings of securities (see Chart 5.3).² Meanwhile, securities issued in vulnerable countries went up by 4.1%. However, due to a slower growth rate compared with other securities, their share in total securities holdings declined from 19.6% in 2013 to 19.3% in 2014. Investments in domestic securities, mainly Maltese government bonds, fell by 16.7% in 2014, to 7.8% of the total securities portfolio.



² Vulnerable countries include Cyprus, Greece, Ireland, Italy, Portugal, Slovenia and Spain.

Funding and liquidity

As in previous years, non-core domestic banks continued to fund their activities primarily from wholesale sources, which provided €2.5 billion of funding, financing 41.1% of total assets as at end-2014 (see Chart 5.4).³ Wholesale funding is primarily made up of loans from, and deposits placed by related credit institutions along with repos with non-bank institutions. During the year the increase of 8.3% in wholesale funding was attributable mainly to higher repos with non-banks. Conversely, MFI loans and deposits predominantly from related institutions, which are also considered part of wholesale funding, fell from 32.5% of total liabilities in 2013 to 27.2% in the subsequent year.



By December 2014 Eurosystem funding increased owing to greater participation in longer-term refinancing operations by one bank. Such funding financed 4.0% of total assets as at December 2014. Likewise, deposits (including loans) from the non-MFI sector rose over the previous year, accounting for 21.6% of total liabilities. Capital and reserves covered 8.9% of total liabilities, down by 9.9 percentage points over 2013. This fall was mainly attributable to the consolidation of a bank's operations in Malta. Meanwhile, resident liabilities expanded by 24.8% in 2014, and accounted for around one-fifth of total liabilities. This increase resulted from higher deposits from households and non-financial corporates. In the same vein, resident deposits held by this group of banks covered 7.6% of total resident deposits in Malta, up by 0.5 percentage point over 2013.

Other resident liabilities include securities issued on the Malta Stock Exchange (MSE) by non-core domestic banks. In 2014 these increased by around €20.2 million to reach €66.1 million. These issues represented 4.8% of the overall bonds listed on the MSE.

The liquidity of non-core domestic banks remained ample, despite declining somewhat during the year. Specifically, the liquidity ratio stood at 82.1%, down from 95.9% a year earlier, but remaining well above the 30% regulatory minimum set by Banking Rule 05/2007. The drop occurred owing to faster growth in short-term liabilities than in liquid assets.

Profitability

During 2014 the profitability of non-core domestic banks weakened, with this group of banks collectively reporting losses for the first time since 2008. This was, however, mainly attributable to one bank, which incurred higher impairment charges during 2014. If this bank is excluded, the aggregate net profit before tax would have been positive, though 41.2% lower than in 2013. Even though net interest income was up by 23.0%, this was offset by higher impairment losses.

Consequently, the return on equity (ROE) turned negative to -0.2% in 2014 from 5.8% in 2013, while the return on assets (ROA) fell from 0.9% in 2013 to -0.3%. ROE and ROA based on profit after tax stood at -1.1% and -0.2%, respectively (see Chart 5.5).

³ Wholesale funding comprises loans and deposits with banks and repos with banks, and non-banks.

Capital adequacy and leverage

Non-core domestic banks remained well capitalised during 2014, despite a decline in the Capital Adequacy Ratio (CAR) from 24.6% in 2013 to 18.6% in 2014 (see Chart 5.6). Similarly, the Tier 1 (T1) capital ratio fell by 7.9 percentage points to 15.5%, but both ratios remained well above the minimum regulatory requirements. Such declines were largely influenced by the restructuring of two banks, of which one was eventually taken over by another non-core bank, and the contraction of another bank following the parent bank's decision to consolidate group business. Also, risk-weighted assets increased, exerting downward pressure on the capital ratios.

Based on the new regulatory framework, the total capital ratio stood at 17.8%, higher than the regulatory requirement of 8%.⁴ The Common Equity Tier 1 (CET1) ratio and T1 capital ratio both stood at 15.0%, higher than the required minimum of 4.5% and 6%, respectively.

The leverage ratio also continued its decline, falling by 10.2 percentage points to 9.8%.

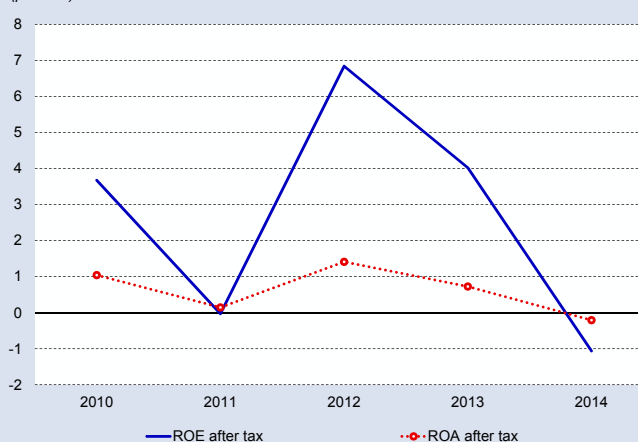
5.1.2 International banks

As at the end of 2014, 12 international banks operated from Malta, as two banks voluntarily surrendered their licence while one bank commenced operations.⁵ In addition, another bank reduced its size by further consolidating its operations through capital positioning within the group. As a result, the total assets of international banks contracted by 1.0%, as these developments more than offset the expansion in the balance sheet of the other banks. In 2014 total assets of international banks amounted to €29.4 billion, equivalent to 369.2% of GDP, down from 392.3% a year earlier. These banks remained profitable, strongly capitalised, with very low credit and liquidity risks.

Asset structure

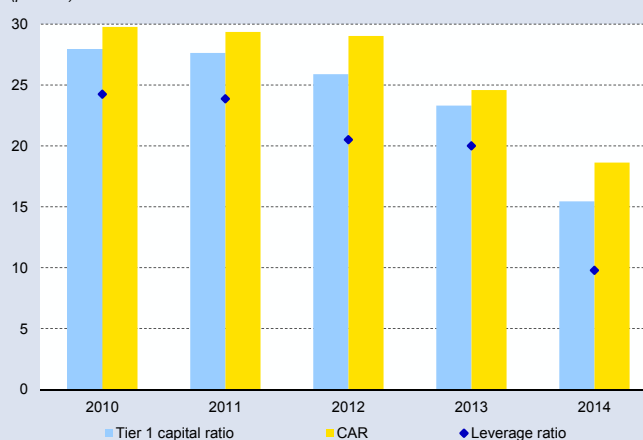
In 2014 the asset composition changed somewhat, predominantly on account of the downsizing of a bank, but also owing to the operations of the two branches of non-EU banks. These branches are the largest in terms of assets size among the international banks. Hence, the operations of these two branches extensively influenced the developments within this category of banks.

Chart 5.5
PROFITABILITY – NON-CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

Chart 5.6
CAPITAL AND LEVERAGE RATIOS – NON-CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

⁴ This refers to the new CRD IV/CRR which came into force in January 2014.

⁵ Erste Bank Malta Limited and Investkredit International Bank plc voluntarily surrendered their licence during 2014. During the same period, Pilatus Bank Limited started its operations.

Indeed, these two branches reported higher holdings of foreign non-MFI securities, predominantly sovereign paper; thus, the share of foreign non-MFI securities in total assets of international banks rose from 33.9% in 2013 to 48.4% in 2014 (see Chart 5.7). Similarly, foreign MFI securities increased by around 24.9% and represented around 6.0% of total assets, up from 4.7% in the previous year. However, these two branches of non-EU banks do not hold securities issued in vulnerable countries or in Malta. The expansion in the securities portfolio was also supported by a simultaneous increase in repos on the liabilities side of the

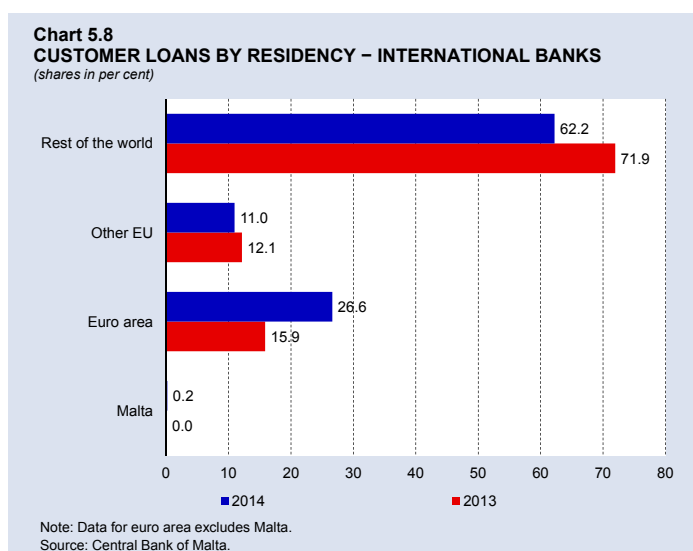
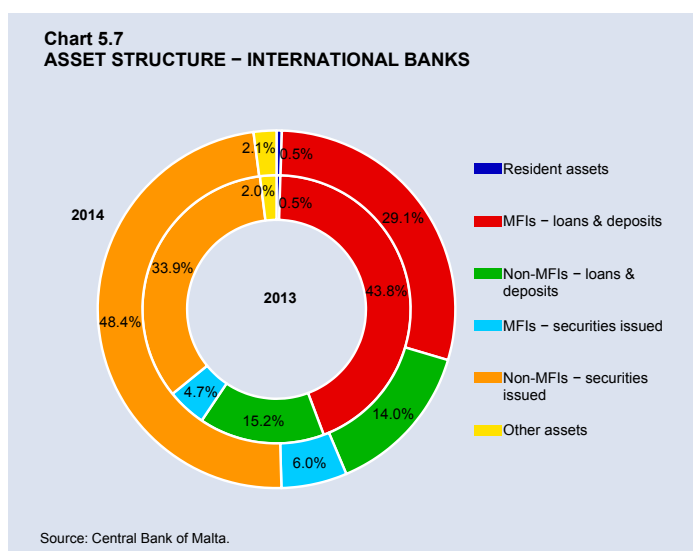
same two branches of non-EU banks. From a geographical perspective, most of the international banks' securities holdings are issued in countries outside the European Union, favouring home bias. In total, these were equivalent to 94.9% of the total securities portfolio.

The increase in securities holdings was completely outweighed by a drop in MFI claims (loans and deposits). Their share in total assets thus declined from 43.8% in 2013 to 29.1% by the end of 2014. This change emanated mainly from the strategic decision of one bank to downsize its balance sheet. Most of the other banks also reduced their interbank loan exposures during 2014. Resident assets remained unchanged at 0.5% of total assets, reflecting the absence of interaction between the banks and the domestic economy.

Lending and credit risks

During the year customer loans contracted by 8.2%, to €4.1 billion, mainly on account of lower loans granted to non-EU residents. This was largely attributable to the two branches of non-EU banks, which reported lower lending to residents of the home country. By the end of 2014, such lending accounted for almost two-thirds of total customer loans, down from around 72% (see Chart 5.8). In contrast, customer loans granted to euro area residents rose by 54.0%, pushing up their proportion to total customer loans from 15.9% in 2013 to 26.6% by the following year. Specifically, higher lending was directed towards Ireland and the Netherlands. Meanwhile, lending to other EU residents contracted and accounted for 11.0% of total customer loans. Loans granted to Maltese residents, however, remained negligible, accounting for just 0.2% of the banks' customer loans.

The NPL ratio of international banks stood at a low 1.4%, marginally rising from 1.2% in 2013. The coverage ratio for this group of banks declined by 1.8 percentage



points to 53.3%, as total provisions dropped at a faster pace compared with total NPLs.

Funding structure and liquidity

The funding structure of international banks is similar to that of non-core domestic banks. Wholesale funding is the main source of funds for the former, representing around 70% of total liabilities, up from around 60% in 2013 (see Chart 5.9). Wholesale funding is predominately made up of deposits (including loans) and repos with unrelated credit institutions. Such funding rose by 17.2% during the year on account of higher repos with unrelated credit institutions

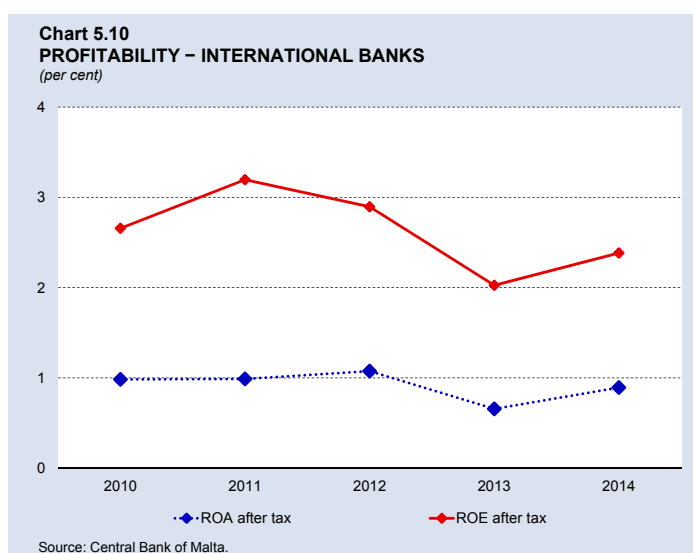
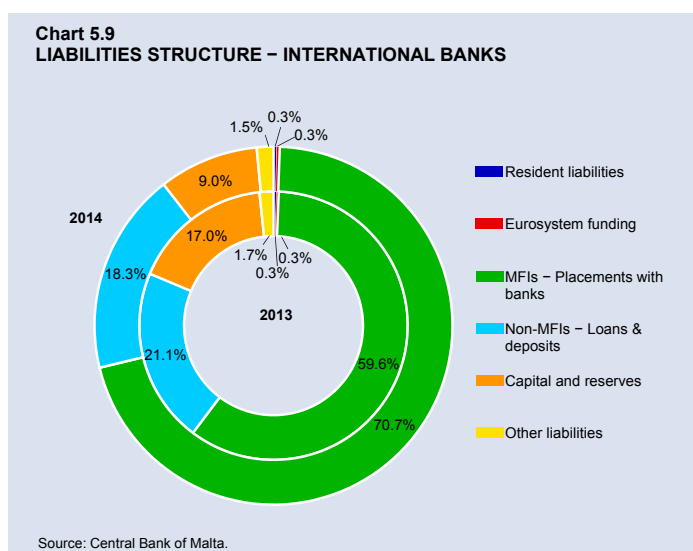
and was mainly used to finance higher securities holdings, as mentioned previously. Meanwhile, funding from non-resident non-MFIs declined by 14.2%, financing just over 18% of the banks' total assets. Resident funding and Eurosystem funding remained minimal, with each source amounting to around 0.3% of total liabilities. Capital and reserves almost halved in 2014, following the scaling down of operations by one bank, making up 9.0% of total liabilities by year-end.

Liquidity levels remained ample, with the liquidity ratio standing at 85.1%, considerably above the regulatory requirement of 30.0%. The scaling down of one bank, however, also impacted this ratio, given that in 2013 it stood at 204.2%.

Profitability

On aggregate, in 2014 international banks reported an improvement in their financial performance, registering an increase of 18.5% in profits after tax. Pre-tax profits rose by 6.5% over the period under review. Higher profits were mainly derived from net interest income, predominantly by the two non-EU branches. Consequently, the ROA based on profits after tax rose from 0.7% in 2013 to 0.9% in 2014 (see Chart 5.10). ROA based on pre-tax profits stood at 1.0% at the end of 2014.

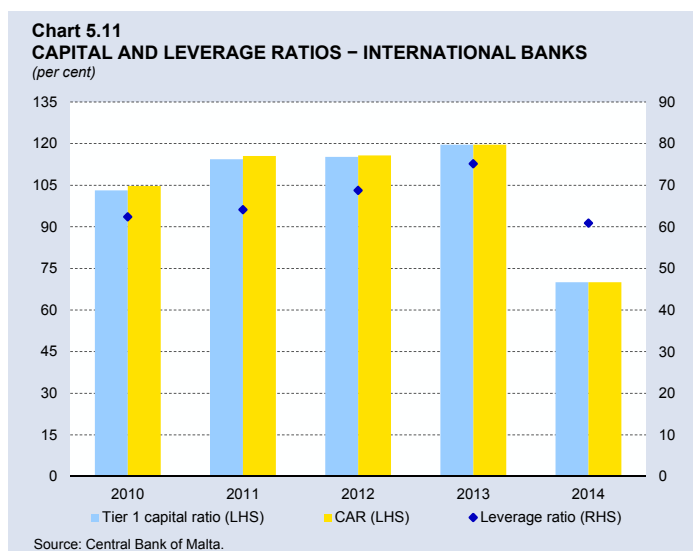
However, if the branches are excluded, profits after tax would have contracted by 45.8% (or 49.2% in pre-tax profits) during 2014. This decline stems from lower net interest income reported by a number of banks. Despite the fall in profits, the ROE of this group of banks would have still improved by 0.4 percentage point to 2.4% in 2014, resulting from a larger contraction in shareholders' funds owing to the scaling down of operations of one bank. ROE based on pre-tax profits stood



at 2.9%, whereas the ROA stood at 1.7%. The latter ratio stands higher than the average of small EU banks, whereas the ROE was in line with EU banks of similar size.

Capital adequacy and leverage

The international banks' capital position remained strong, despite the downsizing of one bank and the contraction in own funds by the other banks in this category. The overall CAR fell from 119.6% in 2013 to 70.0% in 2014, but remained still significantly above the regulatory minimum (see Chart 5.11).⁶ Based on the new regulatory framework, the total capital ratio stood at 69.1%, higher than the minimum regulatory requirement of 8.0%. The leverage ratio fell by around 14 percentage points to 60.9% in 2014.



5.2 Insurance and investment fund sectors

5.2.1 Domestic insurance companies

The local insurance market is composed of insurance and re-insurance companies, whose total assets amounted to €12.8 billion in December 2014, split about equally between the two groups. Insurance companies consist of 35 principals, 11 protected cell companies and seven affiliated insurance companies.⁷ For financial stability purposes, the *Report* focuses on nine insurance principals, given their potential systemic relevance and strong links with the local economy (henceforth referred to as domestic insurance companies). Of these nine companies, three engage in life insurance business and six engage in non-life insurance activities.

The landscape of the insurance sector remained rather concentrated, with two insurance companies accounting for around 89% of the sector's total assets, and almost 60% in terms of gross premia written. Three companies (two life and one non-life) are subsidiaries of two of the core domestic banks. The insurance sector continued to record positive profits albeit lower than in the previous year. Although remaining well-capitalised, the capital position of the insurance companies weakened somewhat during 2014 as the expansion in assets outpaced the increase in capital.

Asset Structure

In 2014 the assets of these nine insurance companies expanded by 53.6% to reach €3.7 billion. The increase stemmed mostly from the life sector, which rose by 60.4% (€1.3 billion), with total assets reaching €3.4 billion. Most of this rise resulted from an insurance company which transferred its portfolio to Malta. Total assets of the non-life sector amounted to €329.1 million by the end of 2014, increasing by 7.2% (€22.0 million) over 2013.

In terms of household wealth, insurance policies sold by domestic insurance companies to domestic households accounted for around 10.1% of households' gross financial wealth – down by around 1 percentage point when compared with the previous year.

⁶ Total own funds of international banks is fully composed of Tier 1 capital. Hence, the Tier 1 capital ratio is the same as the CAR.

⁷ A protected cell company is a company converted into a cell company with the aim of segregating and protecting the cellular assets of the company. A cell is not a separate legal entity. An affiliated insurance company is an insurance company whose business is limited to the risks emanating from shareholders or relating to entities.

Over three-fourths of the insurance sector's total assets, equivalent to €2.8 billion, consisted of investment holdings, which include fixed income securities, financial derivatives, shares, equity and mutual funds. During the year these investment holdings expanded by 65.8%, mainly attributable to the insurance company mentioned earlier, which transferred a foreign portfolio to Malta.

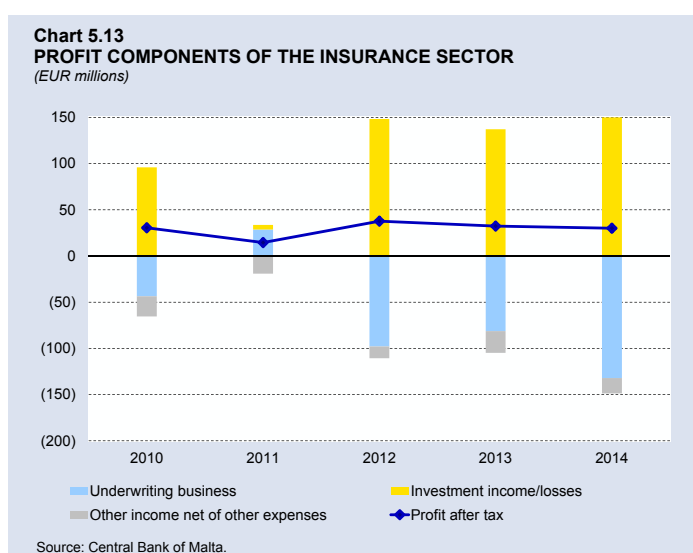
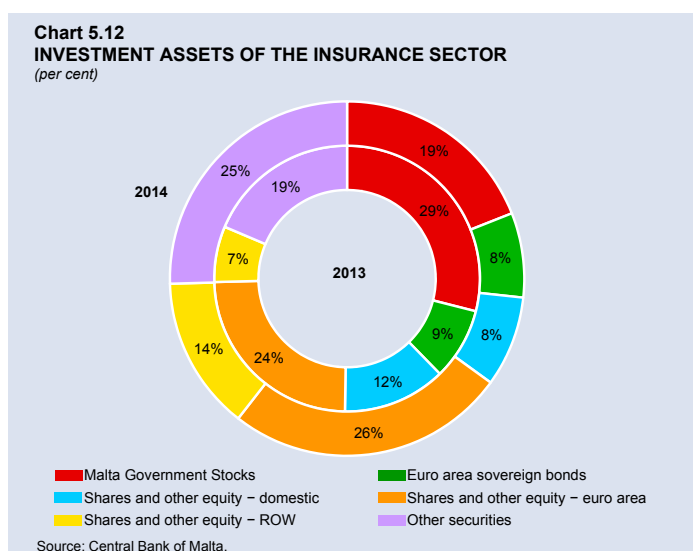
Equity holdings, including mutual funds, represented nearly half (47.8%) of the insurance investment portfolio (see Chart 5.12). More than half of equity holdings consisted of equity issued in euro area countries (excluding Malta), mainly issued in Luxembourg and Ireland by non-bank financial entities. Another 29.3% consisted of equity issued in countries outside the euro area, mainly in the United Kingdom, while the remainder was made up of equity issued by non-bank financial companies in Malta.

During the year there was a shift in the structure of the investment portfolio of domestic insurance companies. Although holdings of Maltese Government Stocks rose by 8.9% in value, their share of overall asset holdings went down to 19.0% from 28.9% in 2013. The fall was due to an increase in holdings of shares and other equity influenced by the new portfolio transferred to the Maltese principal. Another 7.7% of the portfolio consisted of euro area sovereign debt, whereas holdings of bonds issued in vulnerable countries remained low at 4.4% of investment assets.

Profitability

During 2014 the insurance sector's financial performance remained positive, despite a fall of 7.3% in profits after tax, to €30 million (see Chart 5.13). Weaker profits were mainly registered by the non-life sector, which recorded a drop of 15.8% in profits after tax, largely impacted by higher commissions, in view of more business being channelled through brokers and tied insurance intermediaries.⁸ The life sector recorded a marginal slip in profits of 0.8%.

During the year profits were supported by investment income, which improved by over 30.3% (€41.5 million), reflecting better conditions in international capital markets. Meanwhile, proceeds from the underwriting business remained negative, thus weighing on profits. Indeed, underwriting expenses continued to increase as technical reserves set aside for future claims outpaced the reserves brought forward from the



⁸ Tied insurance intermediaries carry out insurance intermediation business in the name and on behalf of a single insurance principal.

previous year.⁹ In fact, technical reserves increased by 63.2%, although they were predominantly affected by the new portfolio transferred to Malta, as mentioned earlier.

However, net premia written climbed by 20.2%, mainly underpinned by the life insurance sector and driven by higher demand for single premium products.¹⁰ Net claims rose by a lesser extent, up by 10.0%. These were also influenced by the life sector on account of maturing and surrendered policies paid out during the year.

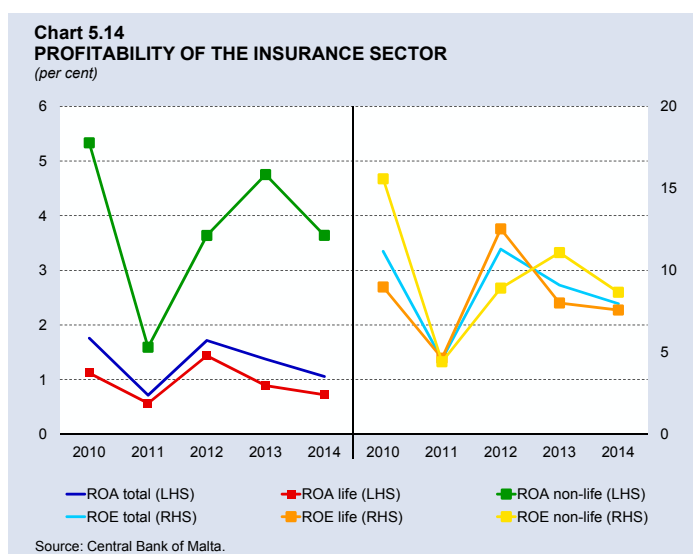
The positive underwriting performance of the non-life sector is also evidenced by their combined ratio, which stood below the 100.0% threshold, standing at 90.8% down from 93.9% in 2013. This improvement resulted from higher net premia, which outweighed the increase in claims and other expenses.¹¹ The median combined ratio of the domestic insurance companies stood at 93.9%, which is in line with the median ratio of large insurance companies in the European Union, standing at 94.8% in December 2014.¹²

The drop in profits reported by domestic insurance principals is also reflected in the ROA and ROE (both ratios based on profits after tax), which declined from 1.4% to 1.1%, and from 9.1% to 8.0%, respectively (see Chart 5.14). The median ROE for large insurance companies in the European Union stood at about 9.2% as at the end of 2014.¹³ The non-life insurance sector recorded the largest drop in ROA and ROE ratios. The ROA ratio of the non-life sector fell from 4.8% to 3.6%, while the ROE ratio declined to 8.7% in 2014 from 11.1% a year earlier. On the other hand, ROA and ROE ratios of the life insurance sector declined from 0.9% to 0.7% and from 8.0% to 7.6%, respectively.

The median-risk-retention ratio for the aggregate insurance sector was estimated at 76.6%.¹⁴ This ratio stood lower than the median ratio of large insurance companies in the European Union of 94%, implying that domestic insurance companies engage more in re-insurance and retain lower risks on their balance sheet than their European counterparts.¹⁵ Despite this, re-insurance links with the domestic economy remain limited, especially since most insurance companies re-insure their risks abroad.

During the year the capital position of insurance companies weakened, driven by an expansion in assets, which was not matched by an equivalent rise in capital. As a result, the capital-to-assets ratio dropped by almost 5 percentage points to 10.2% in 2014. The same ratio in 2014 for the life sector stood at 7.1% while that of the non-life sector amounted to 42.3%.

Internationally, the weak macro-economic environment, in conjunction with rising geopolitical risks



⁹ Underwriting expenses relate to reserves set aside for future claims.

¹⁰ Single premium business relates to policies paid by a single premium payment at the beginning of the term instead of premia being paid over a longer period of time.

¹¹ The combined ratio is measured as the sum of net claims incurred and the net operating expenses as a proportion of net earned premia. A combined ratio of less than 100% portrays underwriting profit as insurers are taking in more in premia than paying out in claims and other expenses.

¹² Source: Statistical Data Warehouse (SDW).

¹³ Source: EIOPA *Financial Stability Report* December 2014.

¹⁴ The average risk retention ratio for the domestic insurance sector stood at 89.1% as at end-2014, that for the life sector at 96.2%, while that for the non-life insurance sector at 77.5%.

¹⁵ Source: SDW. Data refers to December 2014.

and a persistently low interest rate environment, remain key challenges faced by insurance companies abroad. Such macro-financial conditions may compel insurance companies to change their business model, particularly companies engaged in long-term business, given that their long-term obligations to policy holders have become more expensive and unsustainable. Despite these challenges, the domestic insurance sector continued to perform satisfactorily, underpinned by conservative investment portfolio strategies, lack of long-term guaranteed products, as well as strong economic performance, which supports the demand for insurance products. Against this background, risks to financial stability from the domestic insurance sector are deemed to have remained low.

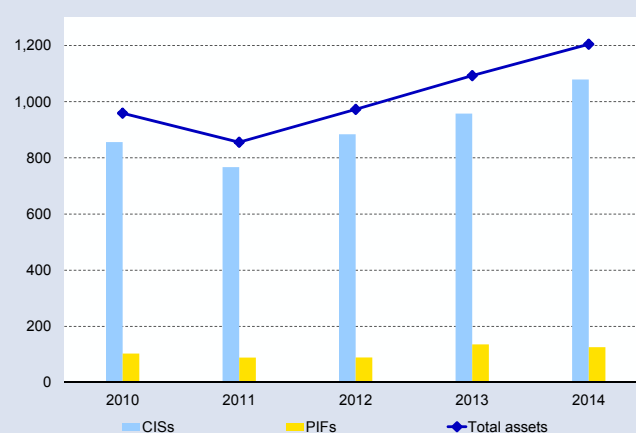
5.2.2 Domestic investment funds

The domestic investment funds sector is composed of Collective Investment Schemes (CIS) and Professional Investor Funds (PIF), with the former accounting for the largest share. As at December 2014, the number of CIS sub-funds licensed by the MFSA amounted to 75. Of these, 27 are considered domestic CIS, given that their fund holders are mainly resident. Meanwhile, by the end of the year there were 520 licensed sub-funds of PIFs, of which only six are considered as domestic, in view of their resident fund holders.¹⁶ This section focuses on developments of domestic CIS and PIFs. Financial stability implications from the domestic investment funds sector are seen to be relatively low.

As at the end of 2014, total assets of the investment funds sector (domestic CIS and PIFs) amounted to €1.2 billion, expanding by 10.2% over the previous year. Growth was entirely attributable to CIS, with total assets increasing by 12.7% to €1.1 billion, owing to a rise in the number of sub-funds and largely attributable to a particular CIS (see Chart 5.15). On the other hand, assets managed by PIFs contracted by 7.3% to €125.5 million, owing to the full redemption of a sub-fund.

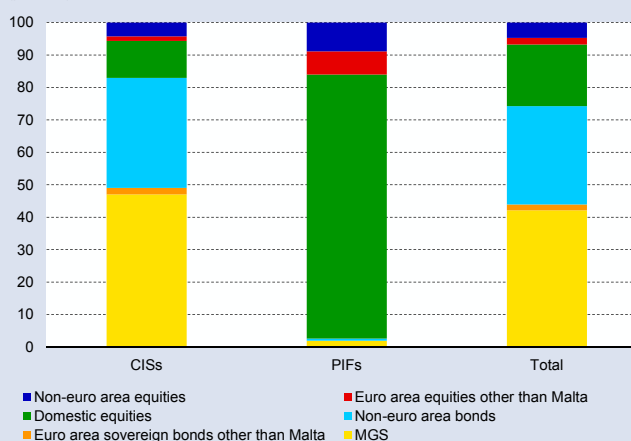
In terms of asset structure, this remained broadly unchanged both for CIS and PIFs. Malta Government Stocks (MGS) remained the main investment asset for CIS accounting for almost half of their

Chart 5.15
TOTAL ASSETS OF THE INVESTMENT FUNDS SECTOR
(EUR millions)



Source: Central Bank of Malta.

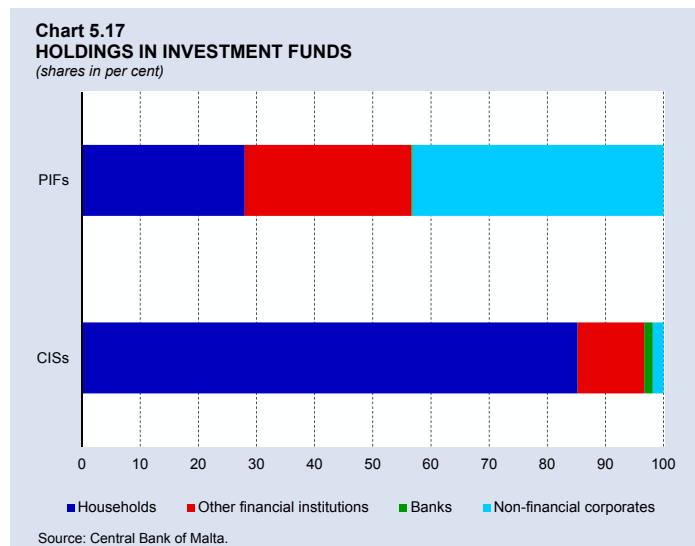
Chart 5.16
ASSET ALLOCATION OF THE INVESTMENT FUNDS SECTOR
(per cent)



Source: Central Bank of Malta.

¹⁶ The Investment Services Act (1994) as amended by Act XVII of 2002 defines CIS as "any scheme or arrangement that has as one of its objects the collective investment of capital acquired by means of an offer of units for subscription, sale or exchange". PIFs are a type of CIS which attract high net worth individuals, i.e. persons or companies that have a higher level of initial capital.

investment portfolio.¹⁷ Such holdings, however, accounted for less than 2% in the case of PIFs (see Chart 5.16). Meanwhile, holdings of euro area sovereign bonds (excluding Malta Government Bonds) remained minimal for CIS, accounting for 2.0% of their investment portfolio. These bonds are mainly concentrated in sovereigns issued in Germany, Italy, Spain and France. On the other hand, PIFs held no foreign government debt. This low exposure implies limited contagion from potential distress in foreign sovereign debt markets.



Meanwhile, the largest investment assets for PIFs consisted of equities issued domestically. These accounted for 81.4% of all assets on their balance sheets, reflecting the unchanged business profile of such funds. Such equities are issued predominantly by MFIs and other financial institutions.¹⁸ Domestic equity holdings represented 11.4% of the CIS investment portfolio and mainly related to non-financial corporations and MFIs.

Core domestic banks continued to manage almost all (85.5%) of the domestic investment funds' net asset value, indicating strong links between the two sectors.

Despite these linkages with the domestic banking sector, the investment funds sector has limited systemic relevance on the economy and the financial sector, mainly owing to its relatively small size, equivalent to just 7.1% of the total assets of core domestic banks, or 15.1% of GDP. Although households account for around 85% of investors in the investment schemes, the latter represent only 4.3% of their financial wealth (see Chart 5.17). Given the higher initial amounts required to invest in PIFs, the major fund holders of such funds are non-financial companies accounting for 43.2% of total fund holders. Meanwhile, households as fund holders of PIFs, increased from 18.0% in 2013 to 28.0% of total fund holders in 2014.¹⁹ However, such holding remains very small at just 0.2% as a proportion of households' net financial wealth.

BOX 4: INTRODUCING COREP (Common Reporting) and FINREP (Financial Reporting)

The first steps towards common reporting commenced with the implementation of the International Accounting Standard (IAS) Directive of 2002. Coming into force in 2005, this directive required IAS and International Financial Reporting Standards (IFRS) to be applied to the consolidated accounts of EU listed banks. Before the implementation of this directive, each Member State applied standards of financial reporting, which included national discretions and variations. The drive towards further harmonisation was boosted by the creation of the Committee of European Banking Supervisors (CEBS) with an advisory role on EU banking supervision, which introduced the concept of

¹⁷ Money market funds (MMF) capture a relatively low share in the local CIS environment. Most CIS engage in a longer-term investment strategy.

¹⁸ These financial institutions include financial auxiliaries, captives, money lenders and non-MMFs, but excludes insurance and pension funds.

¹⁹ Due to a reclassification, the proportion of household fund holders is not comparable with that quoted in the *Financial Stability Report 2013*.

FINREP and COREP in 2005 and 2006. The harmonisation process gathered momentum with the standardisation of reporting dates in 2008.

In 2011 CEBS was succeeded by the European Banking Authority (EBA), which took over the responsibilities of the former Committee. In addition, the EBA was given the mandate to further improve coordination between supervisors, oversee the convergence of financial supervisory practices of EU Member States and to contribute towards the consistent application of EU directives. Within this context, the EBA introduced COREP and FINREP as the new European reporting frameworks for regulated institutions across the European Union. The key objectives include:

- (i) Standardising and harmonising European reporting requirements to reduce the impact on firms of multiple regular reporting requirements from different European supervisors;
- (ii) Establishing a central repository for European banking data, enabling improved risk identification and management for cross-border institutions, while, at the same time, allowing data to be shared easily by national and international authorities, supervisory colleagues, ESRB and ESAs;
- (iii) Facilitating peer reviews, trend predictions and risk analysis to provide greater transparency, especially for cross-border firms.

This common reporting framework came into effect in 2014. The first COREP submission based on the reference period March 2014 was scheduled for May 2014 both on a solo and consolidated basis. The reporting of FINREP began in October 2014, with reference period September 2014. Convergence is well underway as national discretions in this regard, which have been a feature of previous reporting regimes, have been eliminated under the Capital Requirements Regulation (CRR) regime. However, some national discretion is still allowed under the Capital Requirements Directive IV (CRDIV). The EBA remains responsible for the implementation of the new regulation and reporting frameworks.

The definition of COREP and FINREP

The COREP reporting templates are built on the concepts laid down in the CRDIV and CRR for supervisory authorities to monitor adherence to banks' minimum capital requirements and to take any measures, which may be required to safeguard financial stability and maintain healthy buffers. Specifically, data collected in COREP relate to Pillar I requirements of the CRDIV/CRR, including capital adequacy and group solvency, as well as risks identified under Pillar 1 (credit risk, market risk and operational risk). In addition, banks are required to submit data on large exposures, leverage and the two liquidity ratios, the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) (see Figure 1).^{1,2}

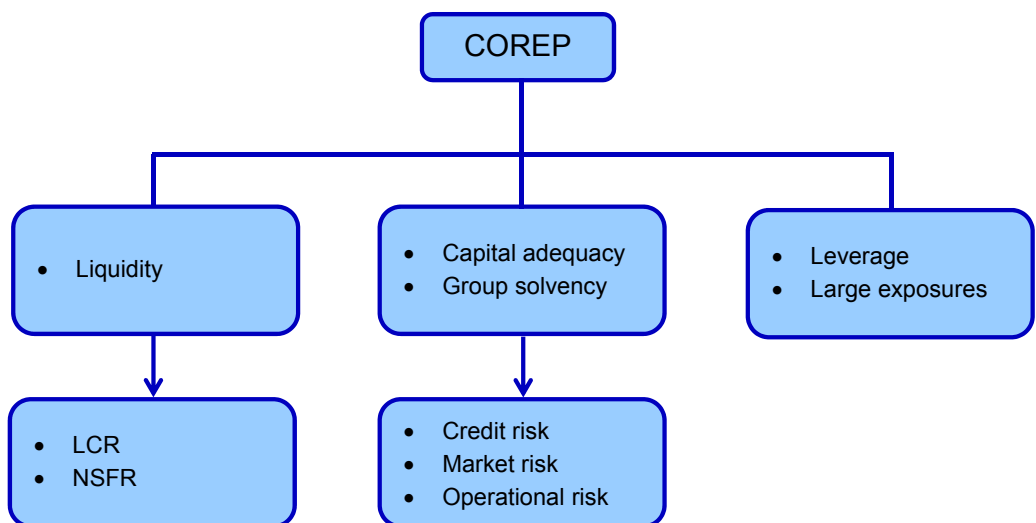
The five capital adequacy templates collect information on:

- (i) different classes of regulatory capital available;
- (ii) capital requirements based on risk weighted assets;
- (iii) capital ratios;
- (iv) capital buffers;
- (v) transitional provisions.

¹ The LCR which is defined as the ratio of high-quality liquid assets to net liquidity outflows over a calendar 30-day stress period. This must be equal to or exceed 100%. It will be introduced in phases starting from January 2015 and should reach 100% in 2018. See http://ec.europa.eu/internal_market/bank/docs/regcapital/acts/delegated/141010_delegated-act-liquidity-coverage_en.pdf.

² The NSFR is defined as the ratio of Available amount of stable funding to Required amount of stable funding, which should be equal to or higher than 100%. See <http://www.bis.org/bcbs/publ/d295.pdf>.

Figure 1
COREP COVERAGE



The template on transitional provisions will cease when the new regulatory requirements become fully operational in 2019. The templates on group solvency gather data on the fulfilment of solvency requirements by all individual entities within a group, according to the scope of consolidation of the reporting entity. The solvency of the whole group and the contribution of each individual entity can be ascertained from these templates. Work is still ongoing to bridge the gap between different reporting conventions in several countries to achieve harmonisation on consolidated reporting.

Credit risk templates show information on asset exposures broken down by type, risk weights, their original value, adjustments for provisions, risk-weighted values and capital requirements. Banks can opt to submit their data based on a standardised or an advanced approach methodology for the measurement of credit risk exposures.³ The templates relating to Pillar 1 risks involve the collection of data on market risk (related to commodities, foreign exchange exposures, equities, debt instruments and securitisations) and operational risk. As in the case of credit risk, banks need to choose one method for calculating risks and the respective capital requirements in agreement with their supervisors for both market and operational risks.

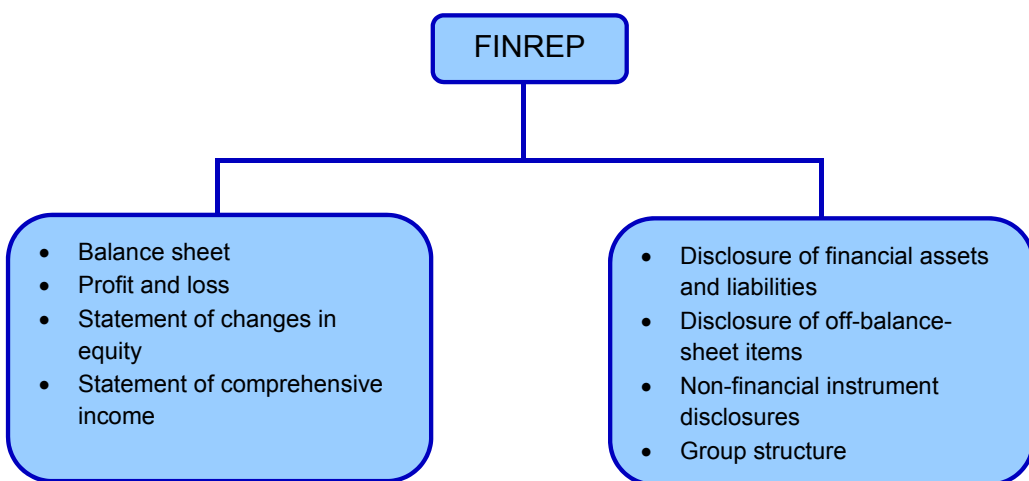
The other COREP templates involve data on assets and liabilities, their duration, flows over specific periods of time, and large exposures.⁴ Such data are used to calculate the leverage ratio and liquidity ratios based on Basel III requirements and assess possible concentration risks.

FINREP are IFRS-based financial reporting templates. The changes that occurred in financial reporting after the start of the financial crisis underlie the concept of FINREP returns. A fundamental change was the replacement of IAS 39 with IFRS 9, with the major changes involving the categorisation of

³ The Standardised Approach is a homogenous method of calculating capital requirements for credit risk based on and supported by external credit assessments. Institutions applying the Advanced Approach or Internal Ratings-based Approach use their own internal estimates of risk components to determine capital requirements for each exposure, subject to meeting certain conditions and supervisory approval. See <http://www.bis.org/publ/bcbs128.pdf>.

⁴ An institution's exposure to a client or group of connected clients shall be considered a large exposure where its value is equal to or exceeds 10% of its eligible capital (Article 392 of the CRR Directive). See <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575&from=EN>.

Figure 2
FINREP COVERAGE



financial assets and calculation of impairments, which is now based on expected losses rather than incurred losses as under IAS 39.

The financial crisis was the catalyst for this change, as accounting practices were obscuring risks present on bank balance sheets. As with COREP, FINREP templates are for supervisory purposes and are based on published accounting data which are of major interest for market analysts and stakeholders. While COREP is used to assess the regulatory impact of exposures, the objective of FINREP is to analyse the business impact of various exposures. FINREP was also introduced to provide regulators with information on strategic decisions taken by banks and to enable supervisors to understand market expectations.

FINREP templates consist of data on balance sheet, profit and loss, statement of changes in equity and statement of comprehensive income. Included are also data on credit losses, allowances for impairment of assets and tangible, and intangible assets (see Figure 2). Other information submitted by banks under FINREP includes a reconciliation exercise between CRR and the accounting scope of consolidation, off-balance-sheet items and information on the group structure.

Process of data submission

Significant banks under the Single Supervisory Mechanism (SSM) framework started submitting their COREP and FINREP returns to the European Central Bank (ECB) in 2014, while less significant institutions (LSI) started submitting such data in April 2015.

Data quality are essential for effective supervision, and the ECB, as the competent authority, undertakes checks to ensure that data submitted are reliable. The process of data collection is structured in a way to ensure that poor quality data (due to inconsistencies or mistakes) are identified. The process of data submission involves banks submitting their data to National Competent Authorities (NCAs), which are then transmitted to the ECB, where the EBA validation process is applied. If poor quality data are identified, the ECB reverts back to the National Authorities or in specific cases to individual banks. Indeed, the interaction between NCAs, banks and the ECB is essential for a smooth data collection process.

Data quality checks are conducted in different stages due to the novelty of the whole process and the large amount of data to be collected. The gradual approach to data checks starts with very basic controls, identifying which banks submitted the data, and whether they were uploaded correctly and in time. The next stage involves a first assessment with automated validation rules and consistency checks, whereas a third stage is based on more detailed and advanced checks. The latter consist of the identification of outliers and the analysis of data for groups of similar banks. Finally, a more comprehensive approach to data quality involves a more detailed analysis, which produces a data quality assessment report. Included are also ratings for each individual bank and a traffic-light approach system for a selection of data points based on failed validation rules.

Over the past decades, domestic banks have submitted their supervisory and prudential data based on the Banking Rules stipulated by the Maltese Supervisory Authority. These data are used by the Central Bank of Malta mainly for their financial stability analysis. However, as from 2014 all credit institutions in Malta were required to change their reporting from the relevant Banking Rules to COREP and FINREP.⁵ For a transitional period, the banks are submitting data based on both the Banking Rules and FINREP and COREP frameworks. Eventually, the data collection based on Banking Rules 02/2011 to 05/2007, and Banking Rule 08/2012, will be phased out. However, National Authorities retain the right to collect additional information over and above that requested by COREP and FINREP, if this is deemed important for financial sector supervision and financial stability.

⁵ COREP replaced BR/02/2011 - Large Exposures of Credit Institutions authorised under the Banking Act 1994; BR/03/2012 Own Funds of Credit Institutions Authorised under the Banking Act 1994; BR04 Capital Requirements of Credit Institutions Authorised under the Banking Act 1994, BR/05/2007 Liquidity Requirements of Credit Institutions authorised under the Banking Act 1994; and BR/08/2012 Capital Adequacy of Credit Institutions Authorized Under the Banking Act 1994.

6. RISK OUTLOOK AND RECOMMENDATIONS

In 2014 the financial sector in Malta displayed ongoing resilience in the face of challenges from the external macroeconomic environment and those inherent to its own industry. Indeed, during the year overall risks to the financial system remained unchanged in substance. However, some risks altered direction, with their severity also easing. Most risks, which are structural in nature, remained broadly stable, whereas those of a cyclical nature changed in line with economic trends.

Looking ahead, the resilience of the financial sector is expected to strengthen further, on the back of favourable economic developments coupled with the adoption of various regulatory measures, primarily to strengthen banks' capital and liquidity positions. These measures came into force in 2014 and will be stepped up gradually over the coming years. Despite a positive economic outlook, banks and other financial institutions should not become complacent to risk, but remain vigilant in their business operations.

Macroeconomic conditions in the euro area remain uncertain owing to country-specific circumstances.

Throughout 2014 economic conditions in the euro area remained muted. Various efforts were instituted in a number of countries to consolidate public finances and undertake structural reforms. These were complemented by further easing in monetary policy, also through the implementation of additional non-standard monetary policy measures by the European Central Bank (ECB). However, fiscal consolidation efforts have led to anaemic investment, contributing to the economic drag throughout the year.

In the early months of 2015, the negotiations over the long-term trajectory of Greek debt re-ignited uncertainty in the euro area and fears for sovereign debt vulnerabilities re-surfaced. However, related contagion implications have been limited, as most countries have strengthened their fiscal balances, with banks reducing their cross-country exposures, particularly to vulnerable countries. Meanwhile, the low inflation environment, coupled with low interest rates, was accompanied by the depreciation of the euro against major currencies and heightened volatility in financial markets.

The Maltese economy is influenced by developments in the euro area, which could have some impact on the financial sector, although the recent past has shown the financial sector to be quite resilient. External macroeconomic developments continue to pose challenges to the financial sector in Malta. Despite the cyclical nature of this risk, the outlook is expected to remain stable over the medium term.

The domestic economy continues to perform strongly, supporting the local financial system. While activity in specific sectors, such as the construction industry, remains subdued, signs of recovery are evident.

From a local perspective, the Maltese economy continued to record strong growth, outperforming the euro area as a whole. Although economic growth was driven by a broad number of sectors, nevertheless, pockets of vulnerabilities persist.

Conditions in the property market improved throughout 2014 as stronger economic growth generated inward labour migration flows, while government measures, including those for first-time property buyers, also provided support to the property market. This was reflected in a pick-up in property prices and in the number of permits issued by the Malta Environment & Planning Authority, the latter being indicative of future activity. Such developments were also reflected in a higher number of sales, indicating a recovery in the real estate market.

The positive economic performance, accompanied by improved provisioning levels, alleviated somewhat the level of credit risk across core domestic banks.

In line with the positive macroeconomic developments, risks stemming from banks' exposure to the construction and real estate sector, whilst remaining a key challenge, have abated. This was reinforced by the banks' increasing prudence in granting credit to this sector. Indeed, banks' measures to reduce concentration in specific sectors is paying off, as the exposure to the construction and real estate sector now accounts for less than a fifth of their corporate lending portfolio.

The rate of increase in non-performing loans (NPL) in the construction sector considerably declined when compared with recent years. This has partly contributed to the tapering off of the overall NPL ratio, thus somewhat easing the pressure on credit risks in the banks' lending portfolio. Core domestic banks also improved their coverage ratio through increased provisioning to cater for the prevailing level of credit risk, as well as through the adoption of more rigorous provisioning on legacy loans.

Overall, the level of credit risk stabilised during the year, underpinned by prudent bank practices and improved macroeconomic fundamentals. These also include households, which continued to build up their financial wealth on the back of strong labour market conditions. From a credit quality perspective, the credit worthiness of households maintained its strength.

Looking ahead, credit risk is anticipated to remain broadly stable as some aspects of credit risk, namely the level of concentration in the banks' loan portfolio, remained high, despite improvements over the year. However, at the same time, one should consider that, apart from requiring a relatively long period of time for banks to broaden their exposures and diversify their lending activities to other industries, there are also structural shifts relating mainly to Malta's economic base: the service sectors, which are generally less reliant on bank funding, expanded more than the traditional sectors, such as the manufacturing industry.

Nevertheless, banks are still encouraged to continue to build up their provisions and capital buffers to mitigate further credit risk.

Pressures on profitability persisted, underpinned by low interest rates and higher impairment charges. The latter included the provisioning for legacy loans, which were not adequately provided for in the past.

Core domestic banks have posted lower profits owing partly to larger impairment charges and operating expenses, arising in part from the Comprehensive Assessment prior to the launch of the Single Supervisory Mechanism in late 2014. Other costs connected with regulatory changes have also impacted profits.

In addition net interest income, a main revenue source for core domestic banks, declined marginally. Banks continued to enjoy low funding costs on the back of their reliance on short-term deposits, intensified by lower interest rates, which resulted in lower interest expenses. Nevertheless, the faster growth in deposits relative to the increase in lending continued to exert downward pressure on net interest income.

Looking ahead, the continuing stabilisation of credit risk and a recovery in credit growth will relieve, to some extent, the pressure on profits. On the other hand, the prolonged low level of interest rates, as well as the impact of the Public Sector Purchase Programme (PSPP) launched in early March 2015, may negatively impact interest income. The latter, however, could be offset by higher capital and revaluation gains on sovereign debt holdings. On balance, the outcome of the PSPP on bank profits is still unknown, at this early stage. Nevertheless, banks are encouraged to continue exercising prudent dividend policies and to build up reserves to sustain capital buffers under the new regulatory framework.

Core domestic banks sought to boost their returns through re-balancing their assets structure. Nevertheless, while this may indicate search for yield behaviour, re-balancing was not aggressive, with banks maintaining prudent practices and conservative investment portfolios.

In view of the historically low interest rates, some banks have sought to improve their financial return to improve profitability. Indeed, core domestic banks have shifted their placements with the Central Bank of Malta to other credit institutions, in view of more favourable rates of return. Nevertheless, banks did not engage in riskier activities and their proportion of risk-weighted assets to total assets marginally declined in 2014 when compared with a year earlier. Hence, risks arising from search for yield behaviour remained muted.

The investment portfolio continued to be dominated by high-quality fixed income securities, with over a third of the holdings of securities pertaining to domestic sovereign debt. Despite such exposure, risks from these holdings are deemed to be low, given declining public sector deficit and sovereign debt as a proportion of GDP, as well as a benign domestic economic outlook. However, in the near term, the PSPP could encourage banks to re-balance further their investment portfolio or increase lending.

Core domestic banks continued to attract deposits, which, however, remained skewed towards the short end of the maturity spectrum.

In 2014 the flow of deposits increased, further augmenting banks' liquidity buffers. While enjoying ample liquidity from customer deposits, the maturity structure of core domestic banks remained predominantly short term, with a maturity of up to one year. Although theoretically this may entail an element of roll-over risk, historically customer deposits have displayed an element of stickiness following a consistently upward path. Depositors' preference for short-term maturities reflects the lack of reward attached to longer maturities and the expectation of better investment opportunities in future, rather than any marked secular change in depositors' savings preferences. This structural feature has not posed financial stability risks in the past. Banks continue to hold enough liquidity in the form of high-quality liquid assets and have sufficient capital buffers to accommodate additional credit demand. Furthermore, in view of the core domestic banks' limited involvement in other funding sources – such as Eurosystem and wholesale funding – these remain a plausible alternative source of funding, should any liquidity needs arise in the future. This is also supported by the high quality investment portfolio, which can be pledged as collateral for additional funding.

Risks to financial stability arising from non-core domestic banks, international banks and other major financial sectors remain limited.

Over the past two years, a number of non-core and international banks have either surrendered their banking licence voluntarily or downsized their operations in Malta. These changes have, in certain cases, been the result of deleveraging by their parent company, as well as owing to restructuring aid granted to parent banks requiring disposal of assets in other countries. Such changes have virtually no impact on the local financial sector or the economy as a whole, as these banks have had very limited linkages with the domestic economy. Nevertheless, their financial conditions continue to be monitored owing to reputational risk. On aggregate, in 2014 non-core and international banks continued to perform positively, and to operate with adequate liquidity and capital buffers, demonstrating low and contained systemic risk. Similarly, systemic risks are also deemed to have remained limited with regard to the insurance and investment funds sectors. The main policy recommendations proposed in the 2013 edition of the *Financial Stability Report* remain valid as they continue to address the more recent challenges discussed above. These recommendations include higher provisioning to cater for credit risk, improved capital allocation to address concentration risk and maintaining prudent dividend pay-out policies to meet the more onerous capital requirements. Banks

are encouraged to be more proactive and to take the necessary measures in terms of new upcoming EU Regulations and Directives, particularly the challenges posed by the Bank Recovery and Resolution Directive (BRRD) with respect to fulfilling the minimum requirements for own funds and eligible liabilities (MREL), and any upcoming revisions to the CRR/CRD IV framework.

Some measures are either being actively considered by banks or are being gradually implemented by the respective authorities and the industry. These recommendations are also in line with those expressed by the ECB following the Asset Quality Review (AQR) conducted on the significant banks in 2014 (see Table 6.1).

Risks	Measures required	Time horizon
Credit risk ⁽¹⁾	Full implementation of BR/09/2013 ⁽²⁾	<i>Short to medium term</i>
	Improve coverage ratio	<i>Short term</i>
	Enhanced valuation methods for real estate collateral	<i>Short to medium term</i>
Concentration risk	Allocation of capital under BR/12/2014	<i>Medium term</i>
Capital requirements ⁽¹⁾	Maintain prudent dividend policies	<i>Short term</i>

⁽¹⁾ To note that significant banks have undertaken an ECB AQR during 2014 and passed the stress test.
⁽²⁾ Full implementation of BR/09/2013 is over three years, ending in 2015.

APPENDIX AND GLOSSARY

APPENDIX: FINANCIAL SOUNDNESS INDICATORS (FSI)

	COMPARATIVE INDICATORS 2011 - 2014 (ALL FIGURES IN %)															
	Core Domestic Banks				Non-core Domestic Banks				International Banks				Total Banks			
	2011	2012	2013	2014	2011	2012	2013	2014	2011	2012	2013	2014	2011	2012	2013	2014
Core FSIs																
Regulatory capital to risk-weighted assets	13.53	14.14	14.86	14.06	29.36	29.02	24.59	18.63	115.53	115.73	119.60	70.03	56.78	55.82	46.20	26.03
Regulatory Tier 1 capital to risk-weighted assets	9.55	10.17	10.99	10.51	27.63	25.89	23.31	15.45	114.37	115.19	119.59	70.01	54.22	53.30	43.88	23.25
Non-performing loans net of specific provisions & interest in suspense to total own funds	44.81	46.84	47.69	45.36	7.06	5.68	5.87	11.47	0.08	0.17	0.79	1.93	5.56	6.15	9.40	17.81
Non-performing loans to total gross loans	7.33	8.20	9.16	9.32	4.47	4.07	4.75	5.09	0.45	0.50	1.16	1.37	3.25	3.78	5.55	6.33
Sectoral distribution of resident loans to total loans																
Agriculture	0.30	0.29	0.30	0.26	0.07	0.07	0.06	0.04	0.00	0.00	0.00	0.00	0.11	0.12	0.16	0.15
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	0.06
Mining & 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	3.57	3.42	3.16	0.34	0.36	0.35	0.26	0.00	0.00	0.00	0.00	1.21	1.41	1.75	1.77
Electricity, gas, steam & air conditioning supply	5.70	2.50	2.37	3.54	0.10	0.11	1.39	1.75	0.00	0.00	0.00	0.00	2.06	0.97	1.34	2.22
Water supply; sewerage waste management & remediation activities	12.09	11.17	10.43	8.94	4.57	4.17	4.41	3.30	0.00	0.00	0.00	0.00	0.27	0.30	0.38	0.38
Construction	9.91	9.40	9.06	9.45	1.22	1.79	0.62	0.35	0.00	0.00	0.00	0.00	4.72	4.67	5.25	4.94
Wholesale & retail trade; repair of motor vehicles & motor cycles	4.63	4.36	4.07	3.80	1.08	0.95	0.80	0.46	0.05	0.00	0.00	0.13	1.78	1.77	2.12	2.19
Transportation & storage	5.50	5.50	5.41	4.89	0.10	0.12	0.10	0.06	0.00	0.00	0.00	0.00	1.99	2.14	2.72	2.68
Accommodation & food service activities	1.37	1.33	1.35	1.05	0.06	0.09	0.07	0.04	0.00	0.00	0.00	0.00	0.50	0.52	0.68	0.58
Information & communication	2.12	5.00	4.58	4.52	0.39	0.23	0.60	0.31	0.00	0.00	0.01	0.02	0.80	1.96	2.36	2.53
Financial & insurance activities	4.05	4.33	4.48	4.84	3.13	3.04	3.95	2.71	0.00	0.00	0.00	0.00	1.71	1.93	2.67	3.09
Real estate activities [includes imputed rents of owner-occupied dwellings]	1.05	0.89	0.51	0.38	0.06	0.04	0.04	0.02	0.00	0.00	0.00	0.00	0.38	0.27	0.26	0.21
Professional, scientific & technical activities	1.13	1.08	1.03	1.01	0.52	0.51	0.51	0.34	0.01	0.01	0.01	0.01	0.45	0.46	0.57	0.61
Administrative & support service activities	1.47	1.49	1.60	1.70	0.00	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.53	0.58	0.80	0.93
Public administration & defence; compulsory social security	0.41	0.43	0.41	0.39	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.15	0.17	0.21	0.21
Education	0.54	0.64	0.66	0.68	0.28	0.27	0.25	0.16	0.00	0.00	0.00	0.00	0.22	0.27	0.36	0.40
Human health & social work activities	0.51	0.73	0.75	0.68	0.36	0.32	0.24	0.14	0.00	0.00	0.00	0.00	0.21	0.31	0.40	0.39
Arts, entertainment & recreation	0.36	0.38	0.41	0.36	0.03	0.03	0.03	0.02	0.00	0.00	0.00	0.00	0.13	0.15	0.21	0.20
Other Services activities	42.95	44.38	46.39	47.61	0.75	0.81	0.70	0.40	0.01	0.01	0.01	0.01	15.52	17.23	23.25	26.12
Households and individuals (excl. Sole Proprietors)	34.60	36.28	38.41	40.27	0.68	0.71	0.57	0.28	0.00	0.00	0.01	0.01	12.51	14.09	19.25	22.08
Mortgages	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
Activities of extraterritorial organisations and bodies	1.65	1.75	1.82	1.90	86.94	87.09	89.85	92.64	99.94	99.98	99.97	99.83	63.51	60.90	49.83	45.07
Non-resident	0.82	1.06	0.95	0.71	0.15	1.41	0.73	-0.21	0.99	1.07	0.66	0.89	0.86	1.10	0.74	0.71
Return on assets*	12.68	15.59	13.07	9.96	-0.03	6.84	4.02	-1.06	3.19	2.89	2.03	2.38	3.75	4.53	3.54	3.65
Return on equity*	72.46	66.80	65.13	64.59	69.96	28.98	56.02	60.57	89.00	124.43	178.01	212.09	79.11	83.14	101.18	114.91
Interest margin to gross income	54.07	45.54	48.01	51.36	45.53	28.69	44.28	44.29	8.87	7.06	10.06	12.36	34.10	27.44	34.89	36.75
Non-interest expenses to gross income	27.54	33.20	34.87	35.41	30.04	71.02	43.98	39.43	11.00	-24.43	-78.01	-112.09	20.89	16.86	-1.18	-14.91
Non-interest income to gross income	24.09	28.81	29.48	31.32	14.88	14.40	16.63	19.92	7.33	9.90	28.14	19.26	16.11	19.64	26.85	27.20
Liquid assets to total assets	44.10	49.07	48.99	49.04	91.41	82.58	95.87	82.10	108.18	145.98	204.20	85.12	49.59	55.61	59.58	53.90
Liquid assets to short-term liabilities																
Other FSIs																
Coverage ratio	35.57	37.59	39.65	44.14	54.35	59.74	41.91	52.07	107.67	95.15	55.11	53.34	43.26	43.64	41.12	45.76
Domestic investment securities to total assets	12.76	11.95	12.10	10.78	2.23	2.87	4.33	3.12	0.00	0.00	0.00	0.00	3.77	3.59	4.10	3.85
Foreign investment securities to total assets	11.46	10.73	11.85	16.61	36.05	38.34	39.29	36.78	31.51	36.49	38.27	53.97	26.37	29.55	30.41	39.87
Unsecured loans to total lending	19.79	19.54	21.83	23.06	39.48	50.73	61.56	66.98	54.24	57.82	60.54	49.08	40.64	42.42	41.32	37.77
Assets to total capital and reserves (**)	15.48	14.54	13.82	14.37	4.19	4.88	5.00	9.70	1.56	1.45	1.33	1.64	3.13	3.14	3.65	6.26
Large exposures to capital	138.48	123.12	133.80	114.01	130.02	111.82	103.98	177.94	10.22	10.78	17.08	44.79	32.22	31.40	45.96	86.39
Gross asset position in financial derivatives to capital	4.89	3.20	2.13	2.82	1.49	0.55	1.32	1.36	0.42	0.54	0.01	0.87	0.99	0.86	0.50	1.58
Gross liability position in financial derivatives to capital	11.56	10.76	5.54	8.83	2.42	2.65	0.75	2.91	0.12	0.07	0.12	0.54	1.55	1.53	1.12	3.58
Personnel expenses to non-interest expenses	52.44	53.92	51.12	51.35	36.24	39.64	44.34	45.53	21.24	25.19	33.19	27.34	46.50	48.45	48.14	47.44
Customer deposits to customer loans	137.51	142.71	150.45	162.13	52.92	68.96	77.42	74.08	71.93	76.06	139.15	129.74	99.53	106.59	138.33	139.31
Net open position in equities to capital	17.74	17.36	17.40	16.65	78.73	75.15	79.52	22.64	0.89	0.28	0.02	0.26	7.68	7.65	10.59	8.79
Net open position in foreign exchange to capital	-0.13	0.03	0.56	1.12	-1.80	0.82	-1.54	-0.16	0.03	-1.21	-0.30	-0.19	-0.10	-0.91	-0.27	0.25
Loan to Value:(***)																
Residential	73.48	70.38	71.49	74.18												
Commercial	63.16	63.19	67.30	69.00												

(*) Based on profit after tax.

(**) Expressed as a ratio.

(***) Based on a sample of 4 domestic banks, updated every June and December.

Glossary

Additional Own Funds/Tier 2 Capital: includes, *inter alia*, undisclosed reserves, revaluation reserves, general provisions, and subordinated term debt.

Bid-to-cover ratio: a ratio that compares the value of bids received in a Treasury auction of a security to the nominal value of the security. The higher the ratio, the higher is the demand.

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

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

Combined ratio: the sum of net claims incurred and net operating expenses as a proportion of net premia earned. A combined ratio of less than 100% signals underwriting profit.

Composite Indicator of Systemic Stress (CISS): an indicator compiled by the European Central Bank (ECB) and is based on 15 financial stress measures split equally in five categories, including the financial intermediaries sector, money markets, equity markets, bond markets and foreign exchange markets.

Construction Confidence Index: is an indicator based on the arithmetic average of the replies to a survey conducted by the European Commission on order-books, employment expectations, price expectations and trends in construction sector activities.

Core Tier1 Capital Ratio: Tier 1 capital is the core measure of a bank's financial strength from a regulator's point of view. It is composed of core capital, which consists primarily of common stock and disclosed reserves (or retained earnings), but may also include non-redeemable non-cumulative preferred stock.

Coverage ratio: the ratio of total provisions and interest in suspense to total non-performing loans (NPL).

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

Currency swap: is a foreign exchange derivative between two parties to exchange the principal and/or interest payments of a loan in one currency in net present value terms, into another currency.

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

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

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

Economic Sentiment Indicator: a composite indicator by the European Commission made up of five sectoral confidence indicators with different weights: industrial confidence indicator, services confidence indicator, consumer confidence indicator, construction confidence indicator, and the retail trade confidence indicator.

ESA 2010: The European System of National and Regional Accounts (ESA 2010) is the new internationally-compatible European Union accounting framework for a systematic and detailed description of an economy.

Eurosystem funding: credit provided to eligible counterparties (banks) on a collateralised basis. The ECB coordinates the operations and the national central banks (NCB) to carry out these transactions.

Forward contract: A customised contract between two parties to buy or sell an asset at a specified price and quantity on a future date. The party agreeing to buy the asset assumes a long position, whereas the party agreeing to sell the asset assumes a short position. Settlement can occur on a cash or delivery basis, and since these are not traded on an exchange, forward contracts are deemed as over-the-counter instruments and less liquid than the other types of derivatives.

Harmonised Competitiveness Indicator: an indicator providing meaningful and comparable measures of euro area countries' price and cost competitiveness that are also consistent with the real effective exchange rates of the euro.

Haircuts: a risk control measure applied to underlying assets whereby the value of such assets is calculated as the market value less a percentage (the "haircut"). The size of the haircut reflects the perceived risk of holding such an asset.

Impaired loans: a loan is deemed to be impaired if there is objective evidence of impairment (i.e. a "loss event"), and that loss event (or events) has (have) an impact on the estimated future cash flows from the loan that can be reliably estimated.

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

Interest burden: all interest payments excluding repayment of principal.

Interest in suspense: the interest due on non-performing assets held in suspense until all the arrears of principal and interest have been settled, or a specific reverse entry is made when they are determined as non-performing. Interest falling due from the date of classification as a non-performing asset should be credited to interest in suspense.

ITRAXX index: is an index composed of credit default swaps covering senior European financials.

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

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

Liquidity coverage ratio (LCR): the LCR promotes the short-term resilience of a bank's liquidity risk profile by ensuring that a bank has an adequate stock of unencumbered high-quality liquid assets (HQLA) that can be converted into cash easily and immediately in private markets to meet its liquidity needs for a 30 calendar day liquidity stress scenario.

Liquidity ratio: the value of liquid assets to short-term liabilities. In terms of Banking Rule BR05/2007 issued by the MFSA, credit institutions are required to hold a minimum liquidity ratio of 30%.

Loan impairment charge: a specific reduction on a bank's profit and loss account adjusting the value of loans.

Loan loss provisions: collective provisions and specific provisions.

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

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

Longer-term refinancing operations: liquidity-providing operations denominated in euro, aimed at providing additional longer-term refinancing to the financial sector against eligible collateral.

Main refinancing operation: a regular open market operation executed by the Eurosystem (in the form of a reverse transaction) for the purpose of providing the banking system with the amount of liquidity that the former deems to be appropriate. Main refinancing operations are conducted through weekly standard tenders (in which banks can bid for liquidity) and normally have a maturity of one week.

MaltaClear: is a local securities settlement system operated by the Malta Stock Exchange and is designated a systemically important securities settlement system by the Central Bank of Malta in terms of Directive No. 2: Payments and Security Settlement Systems.

Marginal lending facility: a standing facility offered by the Eurosystem to credit institutions in order to obtain overnight liquidity from the central bank, against the presentation of sufficient eligible assets. The rate on this facility represents the ceiling for the overnight interest rates.

Net interest income: the difference between the interest generated by a bank from assets and the interest paid on its liabilities.

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

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

Original Own Funds/Tier 1 Capital: the bank's core capital mainly composed of equity capital and disclosed reserves.

Overnight deposit facility: a standing facility offered by the Eurosystem for eligible credit institutions to deposit excess funds with the central bank. The interest rate on the overnight deposit facility represents the floor of the overnight interest rates.

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

Probability of a simultaneous default by two or more large and complex banking groups: it estimates the probability of a systemic event within a period of one year, as measured by the systemic risk measure (SRM). The SRM, which is computed by the ECB, covers a sample of 15 banks.

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

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

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

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

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

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

Significant credit institutions: under the new system of supervision (Single Supervisory Mechanism), the ECB will directly supervise significant credit institutions. The criteria used are (i) the total value of their assets; (ii) the importance for the economy of the country in which they are located or the EU as a whole; (iii) the significance of their cross-border activities; and (iv) whether they have requested or received public financial assistance from the European Stability Mechanism (ESM) or the European Financial Stability Facility (EFSF).

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

Systemic stress: the risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy.

Target 2: Trans-European Automated Real-time Gross Settlement Express Transfer system is a payment system for predominately large-value euro interbank payments in central bank money. This system is operated by three Eurosystem National Central Banks, namely, the Banca d'Italia, the Banque de France and the Deutsche Bundesbank, on behalf of the Eurosystem.

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

Tier 1 capital ratio: Tier 1 capital which is mainly composed of equity and retained earnings, expressed as a percentage of risk-weighted assets.

Targeted longer-term refinancing operations (TLTRO): are aimed at improving bank lending to the euro area non-financial private sector, excluding loans to households for house purchase, over a window of two years.

Total own funds: summation of original own funds and additional own funds.

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

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