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# FINANCIAL STABILITY REPORT UPDATE 2013

This *Update* covers the first six months of 2013 and evaluates developments which may impact the resilience of the domestic financial system since the publication of the *Financial Stability Report 2012*. It also analyses whether any new risks have emerged.[1] The *Update* is prepared by the Financial Stability Department and is subsequently reviewed and endorsed by the Financial Stability Committee of the Central Bank of Malta.


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During the first half of 2013 systemic risks across the euro area abated further, but macro-financial vulnerabilities remained. Heterogeneity across countries persisted with stressed economies still lagging behind in terms of economic growth and other macro-financial developments.[2] Against this background, the domestic economy remained resilient supported by a sound financial system. Core domestic banks continued to report healthy profits, which contributed to further strengthen their capital ratios. Liquidity also remained ample. Deposits increased further but the flow of credit contracted marginally, partly reflecting modest economic growth. Credit risk remained a vulnerability owing to the weak activity in certain economic sectors that rely extensively on domestic bank borrowing. Higher non-performing loans (NPL) and concentration of lending still presented the main challenges for the core domestic banks. Meanwhile, risks to the financial system from other sectors were low. The measures required to address the key risks mentioned in the *Financial Stability Report 2012* remained relevant.

## External macro-financial conditions remained challenging although a gradual improvement is anticipated. The underlying strength of the domestic economy continues to be supportive of financial stability.

The weak international economic environment persisted during the first half of 2013, with the euro area economy forecasted to contract by 0.4% in 2013.[3] Nevertheless, a number of developments point towards a gradual recovery with euro area economic activity projected to grow by 1% in 2014. Signs of an economic recovery were also evidenced by the improvement in the Eurozone composite Purchasing Managers' Index (PMI) which returned to a level above 50 in August 2013.[4] Financial markets in Europe were also calmer, with lower volatility and a rise in equity prices, while the composite indicator of systemic stress eased to pre-crisis levels.[5] Nevertheless, elevated public debt, high unemployment rates, and tight credit conditions remain major challenges. For this reason, the European Central Bank (ECB) is expected to keep its main refinancing rate at a low level for an extended period of time and has also indicated that it will inject more liquidity, if needed, through another round of three year long-term refinancing operations (LTROs).

Although uncertainty in the financial markets continued to abate, developments were not entirely free from bouts of tension. In March, Cyprus became the fifth country to request a European Union/International

[1] The cut-off date for information published in this *Update* is 6 September 2013.
[2] Stressed economies include those of Cyprus, Greece, Italy, Ireland, Portugal and Spain.
[3] Source: ECB Staff macroeconomic projections for the euro area (September 2013).
[4] The PMI is a key benchmark indicator for measuring the business and economic conditions. It ranges between 0 and 100. A reading of 50 means that the variable is unchanged; a reading over 50 indicates an improvement while anything below 50 suggests a decline.
[5] The DJ Stoxx 600 improved by 1.9% between end 2012 and June 2013.

Monetary Fund (EU/IMF) programme. However, contagion effects on other Member States were limited. Furthermore, tensions eased also as a result of measures introduced by the ECB to instil confidence in the markets. In July the ECB reduced the haircuts and rating requirements on a number of Asset Backed Securities (ABS) classes. Simultaneously, the ECB increased risk-control measures for retained covered bonds to achieve an overall neutral effect on the amount of collateral available. Prior to that, in May, the European Banking Authority (EBA) agreed on recommendations for supervisors to conduct asset quality reviews on major EU banks with the objective of dismissing concerns regarding a deterioration of asset quality. It also published its proposed harmonised definitions of NPLs and forbearance. Subsequently, the EBA published recommendations on capital preservation for EU banks based on the 2011-2012 EBA capital exercise. Meanwhile, in July, the European Commission proposed the establishment of a Single Resolution Mechanism (SRM) to complement the Single Supervisory Mechanism (SSM). The SRM will be responsible for managing more efficiently the failure of any bank in the euro area and in other participating Member States in the Banking Union.

Economic developments in Malta during the first half of 2013 remained positive, with GDP growth estimated at 2.8%, significantly higher than the 0.8% recorded a year earlier. Net exports and inventories provided the impetus to growth as domestic demand remained weak. Activity in the construction sector remained subdued, with its contribution to gross value added declining marginally. Meanwhile, the economic sentiment indicator for Malta improved, standing above its historical average level.[6] In 2014, the economy is projected to grow by 2.0%, with the unemployment rate expected to remain stable at 6.3%.[7]

## The balance sheet of core domestic banks contracted slightly, but still mostly funded by customer deposits, maintaining healthy loan-to-deposit ratios.

The aggregated balance sheet of core domestic banks contracted marginally from a total of €14.7 billion in December 2012 to €14.6 billion in June 2013. Interbank exposures (i.e. loans, deposits and repos) were the main components which contributed to this decline. These fell by 27.1% during the first half of the year with movements in intragroup deposits predominating. As a result, the share of interbank exposures dropped to 5.6% of total assets in June 2013 from 7.6% in December 2012, with interbank links across resident credit institutions remaining at a negligible level. Lower deposits placed by the banks, mainly due to the repayment of LTROs with the Central Bank of Malta, were another main source of the fall in total assets.

Bank lending continued to represent the largest share of the banks' assets, equivalent to almost 60%, albeit dropping marginally by 0.1%. Resident corporate loans declined by 1.9% during the first half of 2013, mainly attributable to the wholesale and retail, construction and energy sectors. On the other hand, lending to households increased by 2.2%, thus sustaining the growth observed in the same period a year earlier. The increase in household lending was entirely driven by mortgages, which expanded by 2.9%. Consumer credit on the other hand, declined, by 1%. Replies to the Central Bank of Malta's Bank Lending Survey (BLS) continued to suggest that the weakness in credit developments was largely due to demand-driven factors, rather than credit supply constraints. Nevertheless, developments in credit were also likely to have been conditioned by the banks' stance of maintaining tight credit standards for certain economic sectors such as construction and real estate.

In the six-month period to June 2013, banks expanded their securities portfolio by 7.1%, to 24.8% of total assets. This expansion mainly reflects higher holdings of foreign sovereign bonds which accounted for 11.1% of the total securities portfolio. Nevertheless, the tendency for the core domestic banks to invest in domestic government paper continued, with such securities accounting for almost half of their total securities portfolio, or 12% of total assets.[8] However, as banks generally hold such paper up to maturity, despite these securities being available for sale, market price fluctuations of such securities are limited.[9]

[6] The Economic Sentiment Indicator published by the European Commission is earmarked with a long term average of 100. Malta's Economic Sentiment Indicator improved from 98.4 in December 2012 to 105.2 in June 2013.

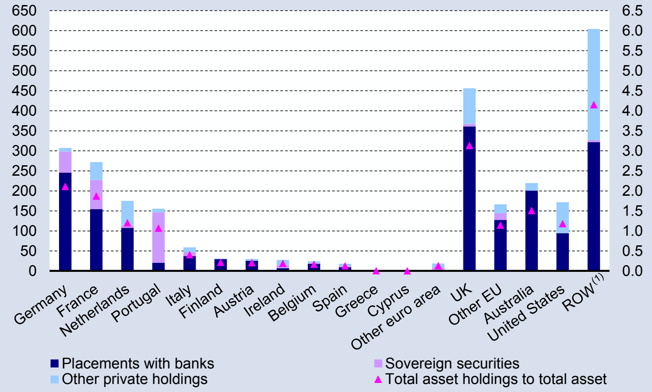
[7] Source: Central Bank of Malta estimates.

[8] This consists of Malta Government Stock (MGS) and Treasury bills.

[9] The amount of securities held for trading purposes remained insignificant, merely 0.8% of the securities portfolio, although 62.5% of the securities portfolio is subject to market price movements in view of their fair value accounting treatment.

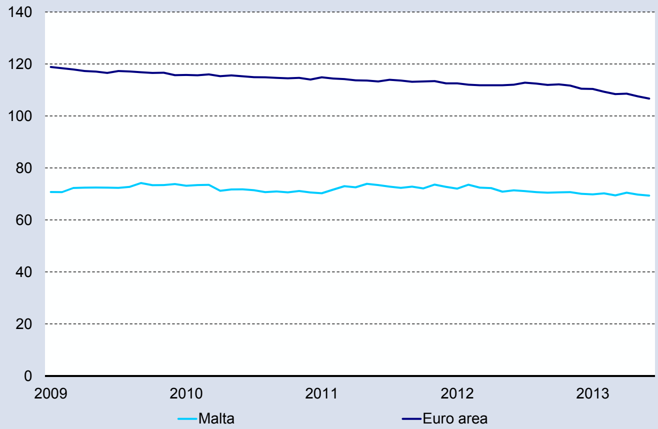
During the first half of 2013, the foreign asset holdings of core domestic banks decreased by 4.1%, and so were equivalent to 18.8% of total assets.[10] The drop was attributable to the banks' placements with non-resident banks (consisting of loans, deposits and securities issued by monetary financial institutions), which declined by 11.4%. Euro area asset holdings amounted to €1.1 billion or 7.7% of total assets. Such assets remained skewed towards countries which to date have shown resilience to the euro area crisis. Indeed, the bulk of the holdings remain in highly-rated securities issued by Germany, France and the UK (see Chart 1). Holdings of securities issued by stressed countries continued to represent a relatively low share of foreign asset holdings, equivalent to 9.5%, although as a proportion of total assets they edged up to 1.8% from 0.9% as at end 2012.

**Chart 1**
**ASSET HOLDINGS OF SELECTED COUNTRIES - CORE DOMESTIC BANKS - JUNE 2013**
*(EUR millions; per cent)*




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

**Chart 2**
**CUSTOMER LOAN-TO-DEPOSIT RATIO - CORE DOMESTIC BANKS**
*(per cent)*




Source: Central Bank of Malta.

As has been evident over the years, customer deposits continued to be the main source of funding for the banks' core activities. They represented 83.8% of their total liabilities as at end-June. During the first half of 2013, customer deposits increased at a slower pace, rising by 1% compared with 3.4% over the same period a year earlier. With loans to customers dropping marginally, the loan-to-deposit ratio declined by 0.7 percentage points over the six month period to end-June at 69.3% (see Chart 2).

The expansion in customer deposits was driven entirely by residents, up by 2.1% in the first half of 2013 for a share in total customer deposits of 83.7%. Both households and, to a lesser extent, corporates contributed to this increase. Non-resident customer deposits in the first six months of 2013, which accounted for 16.3% of total customer deposits, declined by 4.6%. The deposit base continued to be largely made up of savings and current accounts, amounting to 56.7% of total deposits. Meanwhile, term deposits (with a remaining maturity of more than one year) contracted by 15.1%, thus reducing further their share in total deposits to 7.6%, down by 1.4 percentage points from the December 2012 level. The share of term deposits maturing within one year stood at 35.7% of total deposits, just 0.1 percentage points higher than December 2012. Despite their reliance on funding from short term customer deposits, core domestic banks are anticipated to meet the more stringent liquidity regulations stipulated by the CRD IV framework, which lays emphasis on the need for banking institutions to put in place adequate and diversified funding structures.

[10] Asset holdings include securities and placements with banks.

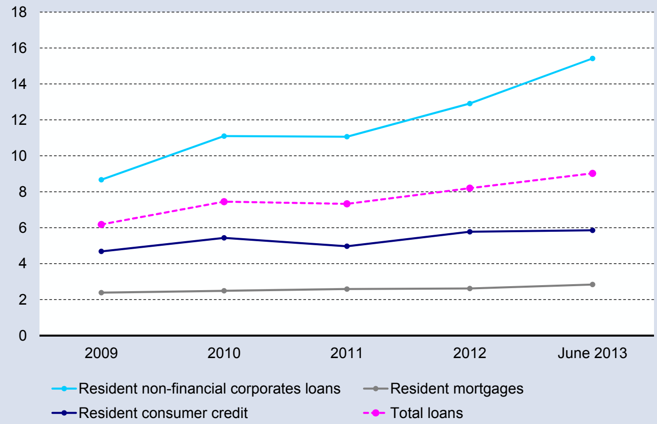
Core domestic banks still make limited use of wholesale funding, despite the availability of such channels. Indeed, as at end-June, interbank funding amounted to just 1.3% of total liabilities, consisting mainly of intragroup financing. Eurosystem funding remained modest, with such borrowings equivalent to just 0.6% of total liabilities, down from 1.7% at the end of 2012. Despite the availability of a relatively high proportion of securities in the core banks' collateral pool, at the end of June, only 0.02% of this pool was utilised for monetary policy operations. This reflects the excess liquidity that the core banks were experiencing. The banks' funding position was strengthened further by the availability of good quality collateral placed with the Central Bank of Malta. Over the six month period to June the core domestic banks did not issue any debt securities and thus liabilities in the form of such securities remained at a level of 2.1% of total liabilities. These were in the majority held by residents.

### Credit risk increased, but was mitigated by higher loan loss provisions.

During the first half of 2013 the total NPL ratio increased from 8.2% to 9.0%, mainly because of a deterioration in the quality of resident corporate loans (see Chart 3).[11] The construction and real estate sectors contributed to almost half of the rise in NPLs, while the accommodation and food services sector contributed to around a quarter. In addition, resident households accounted for 13.5% of the overall increase in NPLs, while the proportion of non-resident NPLs remained low, amounting to just 0.7% of total NPLs.

It should be noted that the resident corporate NPL ratio at the end of December 2012, published in the *Financial Stability Report 2012* was revised upwards from 12.7% to 13.7%. This revision mainly reflected a one-off transaction in the energy sector, which gave rise to a reclassification of outstanding loans from the resident non-financial corporate sector to the financial sector, leading to lower corporate loans.[12] This reclassification had no effect on the extent of NPLs, although it did have an upward impact on the proportion of corporate NPLs to corporate loans (see Table 1).

**Chart 3**
**NPL RATIOS - CORE DOMESTIC BANKS**
*(per cent)*




Source: Central Bank of Malta.

**Table 1**
**ADJUSTMENT IN SECTORAL LOANS AND NPLs RATIO**
*(per cent; percentage points)*

| | Dec. 2012 Before adjustments | Dec. 2012 After adjustments | Difference |
|---|---|---|---|
| Resident corporate NPL ratio | 12.7 | 13.7 | 1.0 |
| Loans to the electricity sector as a proportion of total resident loans | 5.5 | 2.5 | -3.0 |
| Loans to the financial sector as a proportion of total resident loans | 2.2 | 5.1 | 2.9 |

[11] NPLs are defined as loans which are doubtful and irrecoverable. According to Banking Rule BR/09 doubtful loans are credit facilities whose capital and/or interest are overdue by 90 days and over. Such loans also include facilities which irrespective of the repayment not being overdue by 90 days, are considered by banks as giving rise to doubts regarding their recoverability.
[12] This resulted from the creation of a Special Purpose Vehicle for Enemalta Corporation.

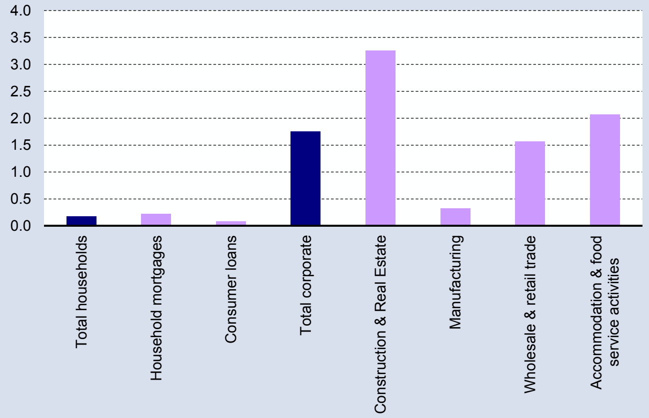
In the first six months of the year, the resident corporate NPL ratio rose from 13.7% to 15.4%. The higher NPL ratio resulted both from a contraction in corporate lending (down by 1.9%) and a rise in NPLs. All major sectors reported a higher NPL ratio, in particular the construction and real estate sectors (see Chart 4).

While, the latter sectors accounted for 15.1% of total resident loans, they represented 46.3% of total NPLs (see Chart 5).

While, the level of household NPLs remained generally low, the quality of household loans deteriorated slightly, as reflected in the sector's NPL ratio, which increased to 3.4% in June 2013 from 3.2% as at end 2012. This increase resulted from a decline in both the quality of mortgage loans (up by 0.2 percentage points to 2.8%) and that of consumer loans (up by 0.1 percentage points to 5.9%). Risks from the household sector are deemed to have remained low, supported by the fact that while household loans account for 46.2% of total resident lending, they represent only 17.1% of total NPLs. Furthermore, the relatively high quality of loans to households continues to be supported by a further accumulation of financial wealth and the low level of interest rates.

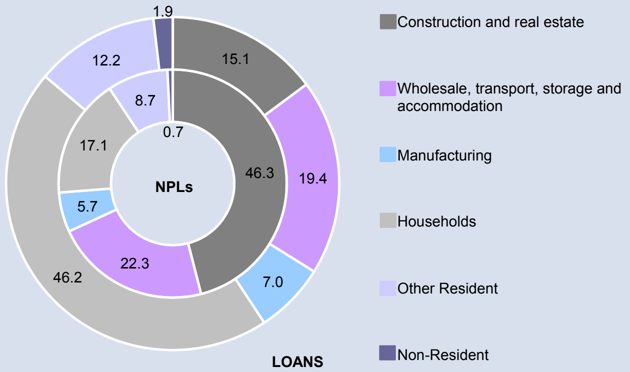
The increase in NPLs was partly mitigated by higher loan loss provisions which increased by 7.7% in the first six months of the year.[13] Since the increase in provisions were lower than the increase in NPLs, the coverage ratio (total provisions and interest in suspense to NPLs) edged slightly down from 37.6% at the end of 2012 to 37.1% at the end of June (see Chart 6).[14] Banks continued to rely mainly on

**Chart 4**
**CHANGE IN NPL RATIO (JUNE 2013 COMPARED TO 2012) - CORE DOMESTIC BANKS**
*(percentage points)*



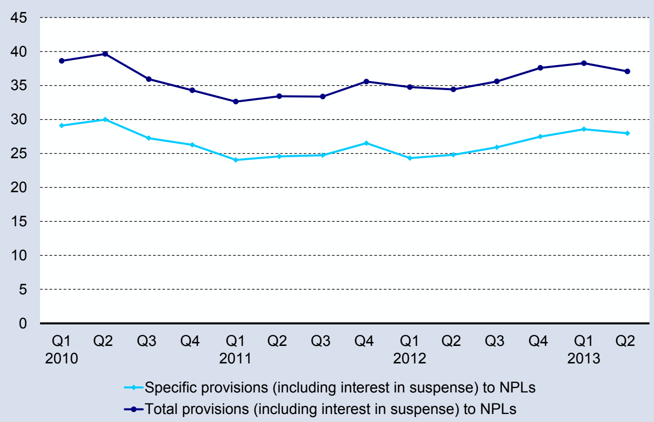

Source: Central Bank of Malta.

**Chart 5**
**SECTORAL ALLOCATION OF LOANS AND NPLs - CORE DOMESTIC BANKS - JUNE 2013**
*(per cent)*




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

**Chart 6**
**COVERAGE RATIOS - CORE DOMESTIC BANKS**
*(per cent)*



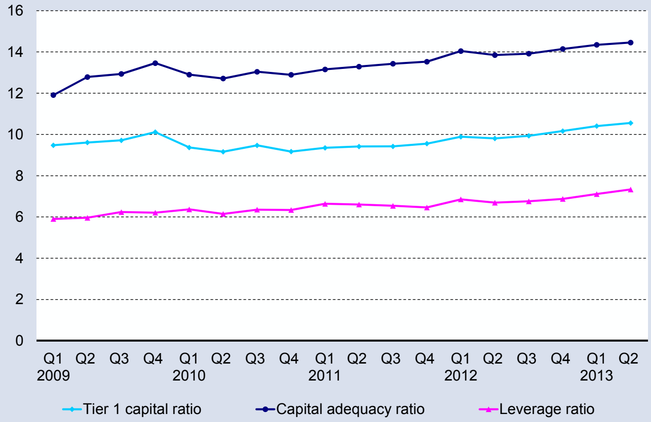

Source: Central Bank of Malta.

[13] The increase in total provisions reflected higher specific provisioning, up by 15.2%, whereas collective provisions declined by 1%.

[14] The coverage ratios were revised in line with the IMF Guidelines on Financial Soundness Indicators which suggest including interest in suspense. Hence, these ratios are not comparable with the coverage ratios published in previous FSR editions.

collateral to mitigate credit risk. Thus, over 72% of total NPLs were covered by collateral mainly in the form of real estate. Hence, the extent of total provisions (including interest in suspense) and collateral more than covers the total value of NPLs. On grounds of prudence, domestic banks kept the loan-to-value ratio at 73.6% and 63.1% for residential and commercial property-backed loans, respectively.[15]

**Chart 7**
**SOLVENCY RATIOS - CORE DOMESTIC BANKS**
*(per cent)*




Source: Central Bank of Malta.

## Liquidity and solvency remained well above current regulatory requirements.

The liquidity position of the core domestic banks remained at a high level with the liquidity ratio, defined as liquid assets to short-term liabilities, standing at 48.0% in June, well above the 30% statutory requirement.[16] The banks' strong liquidity position is evidenced by the elevated proportion of bank holdings of marketable debt securities. These accounted for 60.9% of total liquid assets. Balances held with other credit institutions and the Central Bank of Malta were equivalent to around 34% of total liquid assets.

Meanwhile, the banks' capital position improved further in the first half of 2013, as both the Tier 1 capital ratio and the Capital Adequacy Ratio (CAR) rose by 0.4 and 0.3 percentage points, to 10.6% and 14.5%, respectively, well above the statutory requirements of 4% and 8% (see Chart 7). The improvement in the capital position reflected an expansion in total own funds, mainly in the form of retained earnings, which were up by 2.3%. This outweighed the marginal increase of 0.1% in risk-weighted assets. The leverage ratio, measured as capital and reserves to total assets, also improved by 0.5 percentage points to 7.3%.

In measuring the solvency position of core domestic banks various stress test exercises were conducted by the Central Bank of Malta. Indeed these tests indicate that the loss absorbing capacity of banks improved slightly during the first half of 2013, thus placing banks in a better position to withstand adverse shocks to their capital. The stress tests focused on:

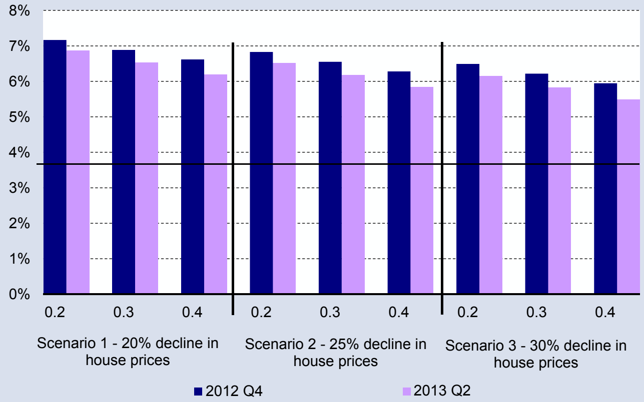
i) asset quality deterioration,
ii) an economic downturn, and
iii) a downward correction in house prices.

The univariate stress test scenarios considered during the first half of 2013 remained broadly similar to those published in the *Financial Stability Report 2012*; with the exception of the house price correction stress test, where the methodology was revised slightly.[17] Given this revision to the methodology, results obtained are not comparable to those reported in the *Financial Stability Report 2012*. In order to facilitate such comparability, Chart 8 presents the results of December 2012 data on the basis of the revised methodology and com-

[15] The loan-to-value ratio is based on a sample of the first 50 new loans approved by four out of five core domestic banks.
[16] BR/05/2007 Liquidity Requirements of Credit Institutions authorised under the Banking Act 1994.
[17] The house price correction stress test aims at quantifying the impact of a drop in house prices, accompanied by an increase in NPLs. Following an in-depth analysis of movements in the NPL ratios of other euro area countries, it was observed that the highest year-on-year increase in NPLs amounted to around 30%. Given that such an increase was influenced by exogenous shocks to the economy over and above the fall in house prices, it was decided to incorporate three scenarios to assess the impact of an increase in NPLs by 20%, 30% and 40%. The methodology used in computing the impact of the simultaneous shocks on banks' capital position was also slightly amended.

pared with those relating to the latest available data as at June 2013. The results show that Tier 1 capital remains well above the statutory minimum requirement of 4%.

Chart 8
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 calculations.

A fourth stress test on liquidity, which considers a persistent deposit withdrawal, indicates that the liquidity position of the financial system was only very marginally weaker than the results published in the *Financial Stability Report 2012*.

### Banks' profitability improved, driven by higher trading profits, despite lower income from financial intermediation activities.

The banks' half-yearly profits amounted to just over €124 million, up by 10.8% compared to the same period a year earlier (Table 2). The return on equity (ROE) of banks remained stable at 23.9% while their return on assets (ROA) improved marginally from 1.6% in December 2012 to 1.7% in June 2013.[18] Higher earnings emanated from a rise in non-interest income, up by almost 31%, mainly on account of trading profits (fair value movements). Dividend income also increased, albeit to a lesser extent. Profits, however, were negatively affected by lower net interest income, reflecting a drop in interest revenue coupled with an unchanged level of interest expenses. Meanwhile, non-interest expenses were broadly stable, as higher operating costs were offset by lower impairment charges. The latter resulted mainly from a fall in charges for loan loss provisions.[19]

**Table 2**
**MAIN COMPONENTS OF THE PROFIT AND LOSS ACCOUNT**
*(EUR millions)*

| | | | 2012 | | 2013 |
|---|---|---|---|---|---|
| | 2011 | 2012 | Jan. - June | July - Dec. | Jan. - June |
| **Total net-interest income** | 314,414 | 296,940 | 169,198 | 127,743 | 154,843 |
| **Net interest income on intermediation** | 223,487 | 212,811 | 120,818 | 91,994 | 118,733 |
| **Other net-interest income** | 90,927 | 84,129 | 48,380 | 35,749 | 36,111 |
| **Non-interest income** | 119,479 | 126,970 | 72,592 | 54,379 | 94,945 |
| **Trading profits**[1] | -27,770 | -313 | 3,736 | (4,049) | 21,488 |
| **Other non-interest income** | 147,248 | 127,284 | 68,856 | 58,427 | 73,457 |
| **Non-interest expense** | (260,032) | (232,298) | (129,530) | (102,768) | (125,441) |
| **Net profit before tax** | 173,861 | 191,613 | 112,260 | 79,353 | 124,347 |

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

[18] The ratios are calculated on the basis of a four-quarter moving sum of profits and a 12-month average in the case of the denominator.
[19] Net impairment charges reflect the net balance of write-offs less write-backs, and provisioning charges less recoveries.

## The other components of the Maltese financial system also remained robust.

Since the publication of the *Financial Stability Report 2012* the level of risk and systemic implications arising from the rest of the financial system remained subdued. Indeed, the resilience of the non-core domestic banks, international banks, domestic insurance companies and investment funds remained robust, with healthy capital and liquidity levels.

During the first half of 2013 the aggregate balance sheet of **non-core domestic banks** expanded by 3.9%, largely due to the operations of a single institution. The expansion in these banks' assets mainly reflected a larger portfolio of foreign sovereign and corporate securities, as well as foreign corporate loans. The links of non-core domestic banks with the Maltese economy remained limited, with loans to residents declining by 9%. Such lending was equivalent to 2.6% of total bank credit outstanding to residents at the end of June. Holdings of domestic government paper by the non-core domestic banks increased significantly, but still accounted for only 4.9% of total outstanding government debt.

These banks continued to rely on the wholesale market as their source of funding. Such borrowing accounted for 46.1% of their total liabilities at the end of June, while total customer deposits amounted to 23.8%. Of the latter, resident deposits increased by 10.4% over the half year and were responsible for financing 13.2% of the total assets of the non-core domestic banks. However, despite this rapid increase, such deposits continued to represent only a small proportion of total resident customer deposits at 6.5%. The reliance of this category of banks on Eurosystem funding also remained low at 3.6% of the total liabilities of such banks.

With regard to their capital position the non-core domestic banks registered healthy capital adequacy ratios, with the CAR standing at 26.4%, predominantly in the form of Tier 1 capital. The leverage ratio also confirms their strong capital position, standing at 20% in June 2013. Similarly, the liquidity ratio remained at a very high level of 74.1%. During the first six months, non-core domestic banks reported a fall of 34% in pre-tax profits, driven by lower non-interest income, when compared to the corresponding period of the previous year. These changes largely reflected developments in one bank and were not replicated in other banks. If this bank were to be excluded from the category, the profitability level would have increased by more than two-thirds.

The group of **international banks** reported a marginal expansion of 0.4% in their balance sheet, entirely driven by developments in non-EU bank branches.[20] This was mainly the result of higher interbank deposits. In the first half of 2013, two new banks, Agribank Ltd and Ferratum Bank (Malta) Ltd, started operating from Malta. These, however, represent less than 0.1% of the international banks' total assets and thus had a negligible impact on the overall increase. Meanwhile, this group of banks reported lower corporate loans and balances held with the Central Bank of Malta. Their resident lending levels remained negligible.

Wholesale funding continued to be the main source of financing of activities of international banks, amounting to almost 60% of their total liabilities, while customer deposits accounted for another 16.5%. Their funding through the Eurosystem remained marginal and was equivalent to just 0.3% of total liabilities. The links of these banks with the domestic economy continued to be insignificant, with their resident deposit base equivalent to just 0.1% of total liabilities and 0.2% of total resident deposits.

The capital position of the international banks improved further in the first half of 2013, with the CAR reaching 131.5% (almost entirely in the form of Tier 1 capital), while the leverage ratio stood at 73.6%. Their overall liquidity position reached 384.4%, as their liquid assets rose significantly.[21] During the first six months of 2013, total profits dropped by 39.1% when compared to the corresponding period a year earlier. The fall was spread across most of the international banks and reflected mainly lower non-interest earnings.

In the **insurance sector**, the half-yearly performance was characterised by a stable outturn, with companies in this sector reporting a 1% rise in pre-tax profits over the same period of 2012. The marginal increase in

[20] If these branches were to be excluded, the balance sheet would have contracted by 10.3%.

[21] Branches are excluded from solvency and liquidity calculations. Such high ratios are largely attributable to one particular bank. Nevertheless, if this bank is excluded, solvency and liquidity ratios would still remain significantly positive and well above the regulatory minimum.

profits registered by the life sector was partly offset by a drop in the profits of the non-life sector.[22] Net premia written, the major contributor to the profit performance, were up by 11.6%. At the same time, a drop in net claims paid by the life sector also contributed to the profit increase, albeit to a lesser extent. On the other hand, while the non-life sector registered an increase in net claims paid, its underwriting activity remained sustainable as evidenced by the combined ratio which stood below 100% at 97.1%, although results were heterogeneous across companies.[23] Investment income, which increased by 13.6% during the first half of the year, also contributed positively to the profits of the insurance sector. The balance sheet of the insurance sector expanded by 3.0% during the first half of 2013, with the asset structure remaining broadly stable as MGS holdings continued to account for almost a third of the total investment portfolio.[24]

Meanwhile, compared to end 2012, the capital-to-assets position of the insurance sector remained relatively stable at 15% in June (life: 11.1% and non-life: 42.9%), whereas the sector's reserves earmarked to cover future claims (technical reserves) increased by 3.4%. The risk retention ratios rose slightly compared to those prevailing in December 2012, standing at 71.6% for the non-life segment and at 95.4% for the life segment in June.[25]

During the first six months of the year, the total asset value of the **investment funds sector** grew by 3.5%, which was entirely driven by collective investment schemes (CIS), as professional investment funds maintained a stable balance sheet size.[26] The net asset value of the investment funds sector increased by 4%, largely reflecting developments in CIS. The asset structure of CIS featured mainly a large MGS portfolio which maintained a stable share of the sector's investment assets, at around 40%. Professional investor funds continued to invest predominantly in domestic and foreign equities, which stood at 57.4% and 40.5% of investment assets respectively at the end of June.[27]

## Updated risk outlook

Against the background of a challenging international environment, the domestic economy continued to grow underpinned by a financial sector which remained sound and stable. Overall the banks remained well capitalised, profitable and characterised by ample liquidity. However, despite these benign indicators, credit risk remains the main weakness for the banking sector in view of the rising levels of NPLs mainly in the construction and real estate sectors (see Table 3). There is therefore a need for banks to focus their efforts on

**Table 3**
**SUMMARY OF RISKS**

| Main vulnerabilities and risks for the financial system | Type of risk | Change in risk level since 2012 FSR | Risk position as at H1 2013 | | | Risk outlook for H2 2013 |
|---|---|---|---|---|---|---|
| | | | Moderate | Medium | Elevated | |
| Increasing non-performing loans stemming from sectoral activity | Credit | ↑ | | | ● | ↔ |
| Concentration of bank lending and collateral towards property | Credit | ↔ | | | ● | ↔ |
| Challenging conditions for profitability | Profitability | ↔ | ● | | | ↑ |
| High proportion of short-term funding | Liquidity | ↔ | ● | | | ↔ |
| EU sovereign debt crisis | Contagion, Profitability | ↔ | ● | | | ↔ |

[22] A new insurance company, accounting for 0.3% of total assets was included for the first time in this analysis.
[23] The combined ratio is defined as the sum of net claims incurred and the net operating expenses over the net earned premia. A combined ratio of less than 100% signals underwriting profit, as insurers are taking in more in premia than paying out in claims and other expenses.
[24] The insurance sector did not hold any securities issued by stressed countries.
[25] The risk retention ratio describes the extent to which gross premia and risk are being retained by the company by netting out premia which are ceeded out to re-insurers.
[26] Professional investment funds are institutions which were referred to as hedge funds in previous FSR editions.
[27] Only 0.5% of professional investor funds' investment assets were in the form of MGS as at June 2013.

strengthening their coverage ratios. The current level of credit risk, as well as the low interest environment, may lead to downward pressures on bank profits. While liquidity risks and potential implications from the EU sovereign debt crisis remain low and stable, the implementation of the new CRD IV/CRR Framework could still pose some challenges for the banking sector. In a broader perspective however, the expected positive, albeit modest, economic growth should continue to support the financial system to maintain its resilience. Risks to financial stability are thus anticipated to remain relatively unchanged during the second half of 2013.

# APPENDIX

## Appendix: Financial Soundness Indicators

### COMPARATIVE INDICATORS Dec. 2012 - June 2013 - (ALL FIGURES IN %)

| | Core domestic banks | | Non-core domestic banks | | International banks | | Total banks | |
|---|---|---|---|---|---|---|---|---|
| | Dec-12 | Jun-13 | Dec-12 | Jun-13 | Dec-12 | Jun-13 | Dec-12 | Jun-13 |
| **Core FSIs** | | | | | | | | |
| Regulatory capital to risk weighted assets | 14.14 | 14.46 | 28.86 | 26.38 | 115.63 | 131.49 | 55.82 | 56.70 |
| Regulatory Tier 1 capital to risk-weighted assets | 10.17 | 10.56 | 25.72 | 23.94 | 115.09 | 131.49 | 53.30 | 54.37 |
| Non-performing loans net of provisions to capital | 57.03 | 60.92 | 7.41 | 7.35 | 0.17 | 0.10 | 7.49 | 8.33 |
| Non-performing loans to total gross loans | 8.20 | 9.02 | 4.07 | 4.02 | 0.50 | 0.41 | 3.78 | 4.36 |
| Sectoral distribution of loans to total loans | | | | | | | | |
| Agriculture | 0.29 | 0.29 | 0.07 | 0.06 | 0.00 | 0.00 | 0.12 | 0.13 |
| Fishing | 0.12 | 0.14 | 0.00 | 0.00 | 0.00 | 0.00 | 0.05 | 0.06 |
| Mining and quarrying | 0.08 | 0.06 | 0.01 | 0.01 | 0.00 | 0.00 | 0.03 | 0.03 |
| Manufacturing | 3.86 | 3.84 | 0.36 | 0.21 | 0.00 | 0.00 | 1.52 | 1.62 |
| Electricity, gas, Steam and Air Conditioning Supply | 2.50 | 2.16 | 0.11 | 0.61 | 0.00 | 0.00 | 0.97 | 0.96 |
| Water Supply; Sewerage waste management and remediation activities | 0.79 | 0.83 | 0.00 | 0.00 | 0.00 | 0.00 | 0.30 | 0.35 |
| Construction | 11.17 | 10.84 | 4.17 | 2.59 | 0.00 | 0.00 | 4.67 | 4.77 |
| Wholesale and retail trade; Repair of motor vehicles and motor cycles | 9.40 | 8.62 | 1.79 | 0.77 | 0.00 | 0.00 | 3.79 | 3.67 |
| Transportation and storage | 4.36 | 4.20 | 0.95 | 0.83 | 0.00 | 0.00 | 1.77 | 1.83 |
| Accommodation and food service activities | 5.50 | 6.20 | 0.12 | 0.11 | 0.00 | 0.00 | 2.14 | 2.60 |
| Information and communication | 1.33 | 1.24 | 0.09 | 0.10 | 0.00 | 0.00 | 0.52 | 0.53 |
| Financial and insurance activities | 5.00 | 4.78 | 0.23 | 0.32 | 0.00 | 0.01 | 1.96 | 2.03 |
| Real estate activities [includes inputed rents of owner-occupied dwellings] | 4.03 | 4.01 | 3.04 | 3.72 | 0.00 | 0.00 | 1.82 | 2.03 |
| Professional, scientific and technical activities | 0.69 | 0.66 | 0.04 | 0.04 | 0.00 | 0.00 | 0.27 | 0.28 |
| Administrative and support service activities | 1.08 | 1.07 | 0.51 | 0.50 | 0.01 | 0.01 | 0.46 | 0.50 |
| Public administration and defence; Compulsory social security | 1.49 | 1.55 | 0.01 | 0.01 | 0.00 | 0.00 | 0.58 | 0.65 |
| Education | 0.43 | 0.43 | 0.00 | 0.00 | 0.00 | 0.00 | 0.17 | 0.18 |
| Human health and social work activities | 0.64 | 0.67 | 0.27 | 0.25 | 0.00 | 0.00 | 0.27 | 0.30 |
| Arts, entertainment and recreation | 0.73 | 0.80 | 0.32 | 0.26 | 0.00 | 0.00 | 0.31 | 0.36 |
| Other Services activities | 0.38 | 0.40 | 0.03 | 0.03 | 0.00 | 0.00 | 0.15 | 0.17 |
| Households and individuals (excl. Sole Proprietors) | 44.39 | 45.39 | 0.81 | 0.78 | 0.01 | 0.01 | 17.23 | 19.03 |
| Activities of extraterritorial organisations and bodies | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Non-resident | 1.73 | 1.85 | 87.09 | 88.78 | 99.98 | 99.98 | 60.90 | 57.92 |
| Return on assets | 1.63 | 1.68 | 1.89 | 1.54 | 1.26 | 1.00 | 1.42 | 1.24 |
| Return on equity | 23.90 | 23.93 | 9.19 | 7.28 | 3.62 | 3.18 | 6.16 | 5.74 |
| Interest margin to gross income | 66.80 | 62.86 | 36.06 | 41.60 | 124.34 | 146.64 | 85.73 | 91.12 |
| Non-interest expenses to gross income | 45.54 | 45.12 | 32.91 | 40.20 | 7.06 | 6.84 | 28.02 | 30.06 |
| Non-interest income to gross income | 33.20 | 37.14 | 63.94 | 58.40 | -24.34 | -46.64 | 14.27 | 8.88 |
| Liquid assets to total assets | 28.81 | 28.67 | 14.40 | 12.29 | 9.90 | 16.29 | 19.64 | 21.74 |
| Liquid assets to short-term liabilities | 49.07 | 48.02 | 82.44 | 74.08 | 146.25 | 384.42 | 55.61 | 61.55 |
| **Other FSIs** | | | | | | | | |
| Coverage ratio (*) | 37.59 | 37.08 | 59.74 | 64.42 | 95.15 | 104.85 | 43.37 | 42.64 |
| Domestic Investment Securities to Total Assets | 11.95 | 12.53 | 2.88 | 4.80 | 0.00 | 0.00 | 3.59 | 3.90 |
| Foreign Investment Securities to Total Assets | 10.73 | 12.02 | 38.25 | 41.55 | 36.50 | 36.78 | 29.55 | 30.51 |
| Unsecured Loans to Total Lending | 19.54 | 20.20 | 50.73 | 52.97 | 57.82 | 63.00 | 42.42 | 44.16 |
| Assets to Total Capital and Reserves (**) | 14.54 | 13.63 | 4.90 | 5.00 | 1.45 | 1.36 | 3.14 | 3.10 |
| Large exposure to capital | 123.12 | 131.55 | 111.74 | 102.55 | 10.87 | 16.16 | 31.38 | 37.15 |
| Gross asset position in financial derivatives to capital | 3.20 | 2.30 | 0.55 | 2.04 | 0.54 | 0.02 | 0.86 | 0.46 |
| Gross liability position in financial derivatives to capital | 10.76 | 7.04 | 2.68 | 0.98 | 0.07 | 0.33 | 1.53 | 1.23 |
| Personnel expenses to non-interest expenses | 53.92 | 53.24 | 38.41 | 40.70 | 26.26 | 33.40 | 48.41 | 49.09 |
| Customer deposits to customer loans | 142.71 | 144.21 | 68.82 | 69.65 | 76.09 | 89.04 | 106.59 | 115.18 |
| Net open position in equities to capital | 17.36 | 17.66 | 75.95 | 74.84 | 0.27 | 0.02 | 7.65 | 7.80 |
| Net open position in foreign exchange to capital | 0.03 | 7.95 | 0.83 | 1.30 | 11.95 | -0.49 | 9.74 | 0.71 |
| Loan to Value: (***) | | | | | | | | |
| Residential | 70.38 | 73.62 | | | | | | |
| Commercial | 63.19 | 63.11 | | | | | | |

(*) Total provisions and interest in suspense to NPLs
(**) expressed as a ratio.
(***) Based on a sample of 4 core domestic banks