BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

SIXTH FINANCIAL STABILITY REPORT

2013

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ABBREVIATIONS

AQR	asset quality review
BBVA	Banco Bilbao Vizcaya Argentaria
BLS	Bank Lending Survey
BR	Banking Rule
CAR	capital adequacy ratio
CDS	credit default swaps
CIS	collective investment scheme
CISS	Composite Indicator of Systemic Stress
COREP	Common Reporting
CRD IV	Capital Requirements Directive IV
CRR	Capital Requirement Regulation
CT1	Core Tier 1 capital
DCS	Depositor Compensation Scheme
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
ESRB	European Systemic Risk Board
FINREP	Financial Reporting
FSR	Financial Stability Report
FTSE	Financial Times and the London Stock Exchange
GDP	gross domestic product
GVA	gross value added
HCI	Harmonised Competitiveness Indicators
HTM	held-to-maturity
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
LCR	Liquidity Coverage Ratio
MEPA	Malta Environmental and Planning Authority
MFI	monetary financial institution
MFSA	Malta Financial Services Authority
MGS	Malta Government Stocks
MSE	Malta Stock Exchange
MSCI	Morgan Stanley Capital International
NPL	non-performing loan
NSO	National Statistics Office
PIF	Professional Investor Funds
PD	probability of default
PMI	Purchasing Managers Index
REMS	Real Estate Market Survey
ROA	return on assets
ROE	return on equity
RWA	risk weighted assets
SDW	Statistical Data Warehouse
SSM	Single Supervisory Mechanism
SRM	Single Resolution Mechanism
S&P	Standard and Poor’s
TARGET 2	Trans-European Automated Real-time Gross settlement Express Transfer system

COUNTRY ABBREVIATIONS

AT	Austria
BE	Belgium
BG	Bulgaria
CY	Cyprus
CZ	Czech Republic
DE	Germany
DK	Denmark
EA 17	Euro area 17 countries
EE	Estonia
ES	Spain
EU	European Union
FI	Finland
GR	Greece
HU	Hungary
IE	Ireland
IT	Italy
LT	Lithuania
LU	Luxembourg
LV	Latvia
MT	Malta
NL	Netherlands
PT	Portugal
SE	Sweden
SI	Slovenia
SK	Slovakia
UK	United Kingdom
US	United States

THE DOMESTIC FINANCIAL SECTOR

Banks

Core Domestic Banks	Non-Core Domestic Banks	International Banks
APS Bank Limited	BAWAG Malta Bank Limited	AgriBank p.l.c.
Banif Bank (Malta) p.l.c.	Credit Europe Bank NV - Malta Branch	Akbank T.A.S.
Bank of Valletta p.l.c.	FCM Bank Limited	CommBank Europe Limited
HSBC Bank Malta p.l.c.	FIMBank p.l.c.	Deutsche Bank (Malta) Limited
Lombard Bank Malta p.l.c.	IIG Bank (Malta) Limited	Erste' Bank (Malta) Limited
	Izola Bank p.l.c.	Ferratum Bank Limited
	Mediterranean Bank p.l.c.	Investkredit International Bank p.l.c.
	Sparkasse Bank Malta p.l.c.	NBG Bank Malta Limited
	Volksbank Malta Limited	Nemea Bank Limited
		Raiffeisen Malta Bank p.l.c.
		Saadgroup Bank Europe Limited*
		Turkiye Garanti Bankasi A S
		Novum Bank Limited

* Licence suspended with effect from 17 August 2009.

Investment Funds**

Collective Investment Schemes	Professional Investor Funds
APS Funds SICAV p.l.c.	Amalgamated Investments SICAV p.l.c.
Calamatta Cuschieri Funds SICAV p.l.c.	EOS Sicav p.l.c.
Global Funds SICAV p.l.c.	HSBC Malta Funds SICAV p.l.c.
HSBC Malta Funds SICAV p.l.c.	La Valette Funds SICAV p.l.c.
HSBC No-Load Funds SICAV p.l.c.	LandOverseas Fund SICAV p.l.c.
La Valette Funds SICAV p.l.c.	Rascasse Capital SICAV p.l.c.
Malta Development Fund Limited	
Santumas Shareholdings p.l.c.	
Vilhena Funds SICAV p.l.c.	
Wignacourt Funds SICAV p.l.c.	

** The 10 domestic Collective Investment Schemes include 29 sub-funds and the 6 domestic Professional Investor Funds include 7 sub-funds.

Insurance Companies

Life Insurance Companies	Non-Life Insurance Companies
MSV Life p.l.c.	Allcare Insurance Limited
HSBC Life Assurance (Malta) Limited	Middlesea Insurance p.l.c.
GlobalCapital Life Insurance	Citadel Insurance p.l.c.
	Elmo Insurance Limited
	GasanMamo Insurance Malta
	Atlas Insurance PCC Malta

PREFACE

Financial stability reflects the ability of the financial system, comprising institutions, markets and infrastructures, to efficiently supply the necessary credit intermediation and payment services to the real economy to enable it to achieve sustainable growth. It also signifies the ability to allocate savings into investment opportunities and to facilitate the efficient settlement of payments. Financial stability also allows the system to absorb shocks and thus manage risks that may harm its performance and, consequently, the economy.

The *Financial Stability Report*, hereinafter referred to as the *Report*, reviews and assesses the macro-financial conditions and developments of the financial system in Malta. It evaluates the resilience of the system and identifies sources of potential systemic risk. It also makes recommendations to preserve and, when necessary, improve the robustness of the financial system. Furthermore, the *Report* seeks to promote awareness of the workings of the financial system in Malta and of related financial stability issues.

The analysis and information contained in the main text of the *Report* is based on activities of those institutions — banks, insurance companies and investment funds — which play a significant role in the 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 shown in the 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 General, the Director, Market Operations, the Director, Financial Stability & Information Systems, and the Advisor to the Governor.

1. OVERVIEW[1]

During 2013 the external macroeconomic environment remained fragile as world economic growth decelerated. The European Union reported significant cross-country heterogeneity, with several countries posting a contraction in economic activity. This continued to adversely impact the European financial system, especially in the euro area, where the generation of profits by euro area banks remained challenging. However, macroeconomic risks receded somewhat on the back of prospects of an incipient recovery of the euro area economy, albeit still generally weak and fragile. In addition, systemic stress in the banking sector declined markedly, partly reflecting the improvement of euro area fundamentals. The latter was in line with fiscal consolidation and structural reforms, and the gradual return of confidence in the stressed countries, which were able to successfully return to the market for funding. The search for yield and growing risks in emerging market economies have to some extent aided funding conditions of European banks. The banking sector started to build higher capital and liquidity buffers, which increased its shock-absorbing capacity.

Euro area banks, however, need to ensure that the deleveraging process does not unduly reduce the supply of credit. Similarly, continued action by several euro area governments is needed to address public debt sustainability challenges while, at the same time, continue to undertake sound macroeconomic policies which are essential for sustainable economic growth, which in turn supports financial stability.

Although the sovereign debt crisis receded and the sentiment in international financial markets improved considerably during the year, new risks emerged for the euro area. The low level of interest rates, together with idiosyncratic risks arising from emerging markets, have intensified the search for yield across European assets, amplifying the risk of an abrupt reversal in investor sentiment and capital flows.

Meanwhile, progress was reported towards the formulation of a banking union with the European Central Bank (ECB), placed at the forefront as the supervisor for euro area banks. In the last quarter of 2013 the ECB launched its comprehensive assessment of significant euro area banks while the Regulation on the Single Supervisory Mechanism (SSM) was also approved, conferring supervisory powers on the ECB. Furthermore, the Single Resolution Mechanism (SRM) was approved in 2014 and is to be implemented in 2015.

The domestic financial system reaffirmed its strength despite the challenging external environment during the year. The Maltese economy expanded at a faster pace relative to the euro area, with gross domestic product (GDP) growth reaching 2.4% in 2013, contrasting with the 0.4% contraction of the euro area economy. Malta's economic growth was mostly underpinned by domestic demand. The fiscal deficit dropped below the 3% mark, even if debt levels increased further, reaching 73% of GDP. Meanwhile, employment continued to grow at a healthy pace and unemployment remained low and thus supportive of financial stability.

The balance sheet size of the overall banking system contracted to 697.3% of GDP in 2013 from 774.8% in 2012. This was mainly the result of voluntary reduction of operations of a small number of international banks. On the other hand the balance sheet of core domestic banks continued to expand, up by 2.5% in 2013. This mainly reflected higher holdings of securities, up by 8.1%, and a 14.2% increase in placements with the Central Bank of Malta. The loan portfolio, which is the main asset component, increased marginally driven by higher household loans, whereas corporate lending contracted. Core domestic banks continued to fund themselves primarily through customer deposits, which rose by 5.8%, reaching almost 85% of total liabilities. This led the loan-to-deposit ratio to drop further to 66.5%, significantly below the euro area average of 105.8%. Meanwhile, wholesale and Eurosystem funding declined.

During 2013 the risks to the financial sector remained broadly stable, with no major developments emerging. The core domestic banks' asset holdings continued to be predominantly composed of credit facilities and securities holdings, with liabilities backing such assets, mainly consisting of customer deposits. Credit risk

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

remained the key challenge to banks, arising particularly from certain weak performing sectors. The non-performing loans (NPL) reached 9.2% of total loans by the end of the year, reflecting a deterioration in the quality of corporate loans. Owing to this, banks continued to increase their provisioning levels, resulting in higher coverage ratios. To address any further potential threats the authorities implemented the revised Banking Rule BR/09, requiring banks to increase their non-distributable reserves through retained earnings as an additional buffer against credit risk. The core domestic banks' main foreign holdings remained predominantly held in financial assets issued in highly-rated countries, with low exposures to euro area stressed countries and global emerging economies. Core domestic banks remained key players in the domestic government paper market, with such holdings constituting almost half of their investment portfolio.

The core domestic banks' capital buffers improved further, with the capital adequacy and Tier 1 capital ratios reaching 14.9% and 11.1%, respectively, well exceeding the regulatory thresholds. The increase was mainly generated by higher retained earnings and higher equity capital, thus resulting in an improved quality of capital ahead of the comprehensive assessment of the significant banks by the ECB. This was partly in anticipation of the new CRD IV/CRR framework, which calls for enhanced requirements in terms of quality and quantity of capital.

Furthermore, the core domestic banks' liquidity position remained ample, with the liquidity ratio significantly above the 30% minimum liquidity regulatory requirement. The profits reported by core domestic banks declined by 8.6% during 2013, generally owing to lower net interest income, particularly from fixed income securities. However, profitability ratios still compare well with historical averages, and are noticeably better than their EU counterparts. The results of the top down stress test exercise, which are included in this *Report*, also reaffirmed the banks' overall underlying strength to various hypothetical shocks.

Risks arising from other banks in the financial system, classified as non-core domestic and international banks, remained generally low and stable. The balance sheet of these banks contracted on aggregate, reflecting developments by international banks. Meanwhile, solvency and liquidity levels remained healthy. The two groups of banks booked positive profits, even though somewhat lower than in the previous year. Linkages of these banks to the domestic economy and to the financial sector remained very limited. Similarly, systemic risks posed by the insurance and investment fund sectors continue to be low. The insurance sector maintained strong capital levels and technical reserves. Although profits dropped, these still compared favourably with EU firms in the insurance sector.

Table 1.1 provides a general overview of the summary of risks based on the analysis of the financial system. In view of the upcoming regulatory measures, fragile global economic conditions, especially in the euro area, and remaining threats to the financial system, banks are still encouraged to increase their provisioning levels and strengthen their capital through prudent dividend policies. Furthermore, banks should continue to diversify their funding sources while implementing further measures to reverse the contraction in corporate loans.

Table 1.1
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 2013			Risk outlook for 2014
			Moderate	Medium	Elevated	
Vulnerabilities within the financial system						
Increasing non-performing loans	Credit	↔			●	↔
Concentration of bank lending owing to a narrow economic base	Credit	↔		●		↔
Subdued credit growth	Profitability	↑		●		↔
High proportion of short-term funding	Liquidity	↔	●			↔
Interlinkages between bank and non-bank financial institutions	Contagion	↔	●			↔
Vulnerabilities outside the financial system						
Weak activity within the construction sector and low property market turnover	Credit	↔			●	↔
Domestic macroeconomic developments	Credit, Profitability	↓		●		↔
Exposures of the financial sector to the Maltese Government	Profitability	↔		●		↔
Subdued economic conditions in the euro area	Credit, Profitability	↔			●	↓
EU sovereign debt crisis	Contagion, Profitability	↓	●			↓

2. THE MACRO-FINANCIAL ENVIRONMENT

This Chapter summarises the key developments in the global financial environment as well as those in the Maltese economy, since the publication of the 2012 *Report*.

Global economic growth decelerated further during 2013 as the international economic and financial environment remained fragile, underpinned by risks to the financial system. While the sovereign debt crisis receded during the year, it nevertheless still presents an important risk. Furthermore, as the search for yield intensified, in view of expectations of a prolonged low interest rate environment, concerns about the build-up of imbalances and the possibility of a sharp and disorderly unwinding of recent flows have increased. Still, macroeconomic risks appear to have receded somewhat on the back of prospects of a euro area economic recovery, even if it is still generally weak and characterised by heterogeneity across Member States.

Malta posted relatively strong GDP growth coupled with low unemployment levels despite a contraction in the euro area. Government deficit edged down to 2.8% while public debt moved up further during the year.

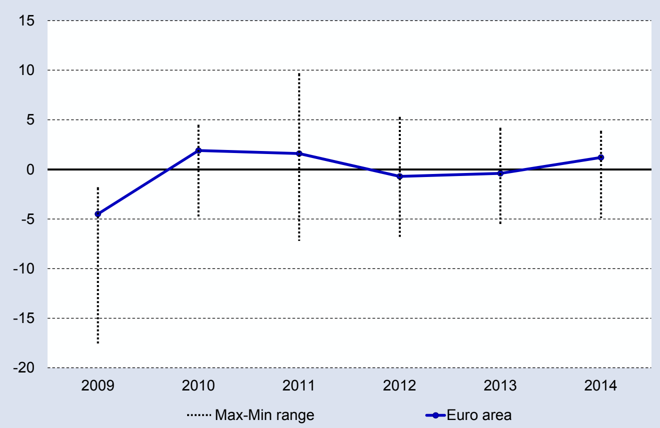
2.1 The external environment

The external macroeconomic environment remained fragile in 2013 as world economic growth decelerated, with global GDP estimated to have grown by 2.9% in real terms, which was 0.3 percentage point lower than in 2012. This slowdown was mainly underpinned by weaker growth in emerging economies. While the United States, the United Kingdom and Japan experienced positive growth throughout 2013, at 1.9%, 1.7% and 1.5%, respectively, the euro area economy contracted, with GDP falling by 0.4% following a decline of 0.7% in 2012.

Within the euro area, there was significant cross-country heterogeneity, with national real GDP growth ranging between -5.4% and 4.1% (see Chart 2.1). Divergences were also observed in the unemployment rate, which increased by 0.7 percentage point to 12.0% for the single currency area, and varied between 4.9% and 27.3% across Member States. Fiscal vulnerabilities persisted in several countries, with euro area government debt increasing further during 2013 and reaching 95% of GDP, although the fiscal deficit narrowed to 3.0% of GDP.

Weak macroeconomic conditions in the euro area continued to adversely impact the European financial system. In particular, euro area banks' profit generation remained challenged, reflecting the frail economic recovery prospects. The sovereign debt crisis during the early months of 2013 spread to Cyprus as it became the fifth Member State requesting a European Union/International Monetary Fund programme. Nevertheless, contagion across Europe was contained. Indeed, after the programme was approved, the sovereign debt crisis receded significantly for the rest of 2013. Meanwhile, the low level of interest rates, coupled with additional risks arising from emerging markets, intensified the search for yield across European assets, thus amplifying the danger of an abrupt reversal of investor sentiment and capital flows. Furthermore, the risk

Chart 2.1
EURO AREA GDP GROWTH RATE
(per cent)



Source: European Commission Spring 2014 Economic Forecast.

of a “double-hit” impact on the life insurance sector increased substantially throughout 2013 as such companies became susceptible to hits on both the liability and asset side of their balance sheet through the prolonged low interest rate environment and a re-assessment of global risk premia.

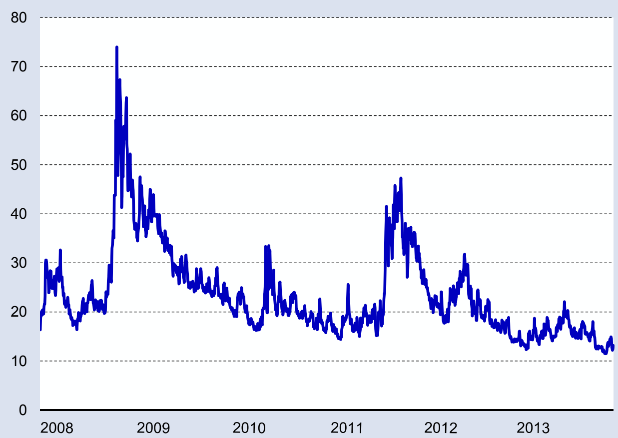
Chart 2.2
DJ STOXX 600 (EUROPE)

Source: Reuters.

Tentative signs of economic recovery in the euro area, however, emerged during 2013, with a number of indicators exhibiting positive developments. Following two years of contraction, euro area economic activity is projected to grow by 1.2% in 2014.[1] This turnaround is also portrayed by positive developments in a number of market indicators. The euro area composite Purchasing Managers' Index (PMI) ended 2013 at 52.1, noticeably above the average levels reported in the last two years.[2] Similarly, the euro area Economic Sentiment Indicator exceeded its long-term average by December 2013. The recovery also manifested itself in the equity market, with the DJ STOXX Europe 600 Index increasing by 17.4% during 2013, reaching levels previously seen in 2008 (see Chart 2.2).[3] The banking component of the index, although still below its pre-crisis level, registered significant improvement, up by 19%. Standard volatility benchmarks, such as the VDAX, also remained at the same low levels as at end-2012 (see Chart 2.3).[4]

The divergence in euro area government bond yields narrowed further during 2013, providing an indication that the sovereign debt crisis has been steadily receding. Core euro area countries also reported a narrowing in their bond spread with respect to the country with the lowest yield in the euro area (see Chart 2.4). Such developments were also mirrored in the sovereign credit default swaps (CDS), in the probability of a simultaneous default by two or more large and complex banking groups and also in the Composite Indicator of Systemic Stress (CISS). As shown in Chart

Chart 2.3
VOLATILITY INDEX - VDAX



Source: Reuters.

[1] Source: *EC European Economic Forecast Spring* 2014.

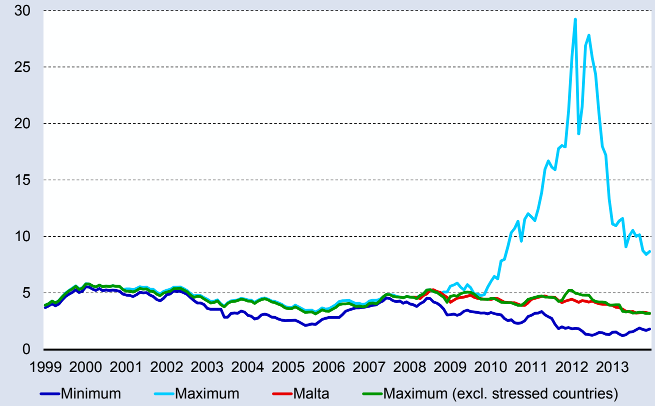
[2] The PMI is a key benchmark indicator of business and economic conditions. It ranges between 0 and 100 with 50 meaning an unchanged variable. A reading above 50 indicates an improvement, while anything below 50 suggests a decline.

[3] 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, mid and small capitalisation companies across 18 countries in Europe.

[4] 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.

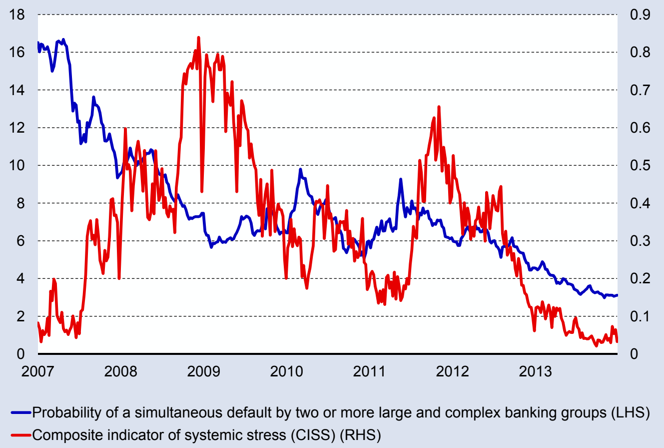
2.5, these risk indicators receded considerably during 2013.[5]

Chart 2.4
DISPERSION OF EURO AREA TEN-YEAR SOVEREIGN BOND YIELDS
(per cent)



Note: Data for Malta is available as from 2008.
Source: Reuters.

Chart 2.5
SYSTEMIC RISK INDICATORS



Sources: Reuters; ECB and ECB calculations.

During 2013 the ECB lowered its key policy interest rate twice, to a new historical low of 0.25%.[6] In addition, the ECB agreed that the overnight deposit facility rate would remain unchanged at 0%, whereas the marginal lending facility rate (the ceiling) was also reduced twice to stand at 0.75%. This was mainly motivated by the low level of inflation in the euro area, which dropped by 1.1 percentage points to 1.4% in 2013. Furthermore, forecasts for 2014 indicate that inflation will ease further to 0.8%, which is well below the ECB's price stability objective of an inflation rate that is close to, but less than 2%. This poses some risks to the euro area economy. While, on the one hand, a lower rate of inflation increases real income, on the other hand, if further declines in inflation to very low levels usher increased expectations of deflation, households could postpone consumption expenditure in anticipation of lower prices in the future, which would create a downward spiral in consumption and prices, thus prolonging economic weakness.

In a bid to support economic recovery, the ECB continued to implement its non-standard monetary policy measures. Since July 2013, the ECB joined other major central banks in providing forward guidance on the future path of its policy interest rates. Furthermore, in November 2013, the Governing Council announced that it will continue conducting its main refinancing operations and the maintenance period refinancing operations as fixed rate tender procedures with full allotment at least until 7 July 2015. Furthermore, the ECB announced that the three-month longer-term refinancing operations will also be fully allotted at fixed rate tender procedures till June 2015.

Among other measures, in October 2013 the ECB decided, together with the Bank of Canada, the Bank of England, the Bank of Japan, the Federal Reserve, and the Swiss National Bank, to convert the temporary bilateral liquidity swap arrangements to standing arrangements that will remain in place until further notice with the aim of using the swaps as prudent liquidity backstops. Also, the ECB and the People's Bank of China agreed to establish a bilateral currency swap arrangement to ensure financial market stability. In March

[5] 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 (SRM). The SRM covers a sample of 15 banks. Source: *ESRB Risk Dashboard*, Issue 7.

[6] The ECB cut its main refinancing rate to 0.15% as from the 11 June 2014. Concurrently, the overnight deposit facility rate turned negative to -0.1% while the marginal lending facility rate was cut to 0.4%.

2014, in view of the increased risk of deflation in the euro area, the ECB indicated that additional monetary policy measures may be implemented to maintain price stability.

In an attempt to address fragmentation in euro area financial markets, and weaken the loop between the sovereign debt problem and the banking sector problem, the European Commission had proposed in 2012 the creation of a banking union among Member States. Further progress was achieved over the course of 2013, and by October the Council adopted the Regulation on the Single Supervisory Mechanism (SSM), assigning supervisory powers to the ECB over banks in the euro area, as well as in other Member States that opt to be part of the Banking Union. The ECB will therefore directly supervise significant credit institutions, and within its overall oversight function, will work closely with national competent authorities to supervise all other credit institutions. The ECB may, however, also decide at any time to take direct responsibility for a less significant credit institution.

Meanwhile, in July 2013, the European Commission proposed the establishment of a Single Resolution Mechanism (SRM), which complements the SSM. The SRM would consist of a single resolution authority with access to a single resolution fund to manage any possible bank failures in the euro area and in other participating Member States. The Regulation establishing the SRM was adopted in 2014, with most of its elements coming into effect in January 2015.

BOX 1: AN UPDATE OF EUROPEAN COMMISSION RULES ON STATE AID TO BANKS

In the Banking Communication of July 2013 the European Commission published updated EU rules dealing with state aid to banks applicable as of 1 August 2013, which, in conjunction with other crisis rules, spell out common conditions at EU level on how Member States can provide public support to banks hit by the crisis.[1,2]

The main changes to the Banking communication are intended to:

1) bring a more effective restructuring process;
2) strengthen the burden-sharing requirements with the private sector;
3) ensure a level playing field for banks in EU Member States.

The Banking Communication establishes the principle that bank recapitalisation and impaired asset measures will be authorised only when a restructuring plan has been approved by the Commission.[3] Thus, banks will be required to draw up a plan for their restructuring or orderly winding down before they can receive public support. Furthermore, stakeholders have to contribute to restructuring costs so as to minimise state aid. This means that in the case of a capital shortfall, shareholders and subordinated creditors will be required to first contribute to the cost of restructuring (burden sharing) before resorting to public recapitalisations or impaired asset measures.[4] No contribution will be required from senior debt holders, in particular from insured depositors, uninsured depositors, bonds and all other senior debt holders (not subordinated). In resorting to burden sharing, the “no creditor worse off principle” must be adhered to.[5]

[1] European Commission’s Communication 2013/C 216/01 (http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2013:216:0001:0015:EN:PDF)
[2] It replaces the 2008 Banking Communication and supplements the remaining crisis rules.
[3] Impaired asset measures refer to the establishment of an impaired asset relief scheme for financial institutions similar to National Asset Management Agency (NAMA) in Ireland and Fund for Orderly Bank Restructuring (FOBR) in Spain.
[4] The application of burden sharing can be avoided when it may endanger financial stability or lead to disproportionate results (Para 45 of the 2013 Banking Communication).
[5] The “no creditor worse off principle” ensures that subordinated creditors will not receive less in economic terms than what their instrument would have been worth if no state aid were to be granted.

The Banking Communication provides for two instances whereby burden sharing with the private sector may be implemented. The first instance refers to when minimum regulatory capital requirements are not respected, thus resulting in a capital shortfall. This could, for example, arise from an asset quality review. In this case, when a bank is unable to strengthen its capital position on its own, state aid can only be granted following the contribution from equity holders (through dilution) and the conversion into equity, or write-down, of hybrid capital and subordinated debt. The second instance is when a bank's capital ratio is above the EU minimum regulatory capital requirements but below a threshold set by the supervisor. Such a capital shortfall could, for example, result from a stress-testing exercise. The rule distinguishes between cases when the capital ratio falls below the threshold established for the exercise but remains above the regulatory minimum, and those when the ratio falls below the minimum regulatory requirement. In the first case, before authorising public support, the European Commission requires, in principle, that subordinated debt be converted into equity. In the second case, it must be possible for subordinated debt to be converted or written down, while appropriate time is first allocated to the bank to meet the capital shortfall by its own means. However, if private means to raise capital have been exhausted, the bank would then need to resort to public sources to fill that gap. This would raise doubts about the soundness of the bank and public aid would be the only remaining avenue that would ensure the stability of the financial system. In both cases the application of burden sharing can be avoided when this may endanger financial stability or lead to disproportionate results, especially when the support required is small in relation to the bank's risk-weighted assets.

The revised state-aid framework thus introduces a level of harmonisation of the Rules applicable to bank recapitalisation. In particular, this is essential ahead of results of the ECB comprehensive assessment, which includes an AQR and stress test undertaken in conjunction with the EBA, prior to the ECB taking over the supervision of banks of euro area Member States and other EU Member States that voluntarily opt to become part of the SSM. The modification of these rules could be considered as a further step towards the creation of a harmonised framework with the Bank Recovery and Resolution Directive (BRRD), as from 2015.[6] The BRRD also foresees bail-in in the resolution of banks. The BRRD goes even a step further, when bail-in is imposed on shareholders and unsecured creditors, including junior and senior bondholders and some categories of depositors. The changes to the EC State-Aid Rules for burden sharing have anticipated the coming into effect in 2015 of the bail-in tool (mandatorily applicable by 1 January 2016 at the latest), and also the results of the comprehensive assessment undertaken by the ECB.

At end-December 2013, the extent of subordinated debt instruments issued by domestic banks amounted to 0.5% of total banking assets. The largest portion of these instruments was held by individuals, holding around 75% of these bonds. The remainder were mainly held by resident collective investment schemes, insurance firms, and, albeit to a much lesser extent, by credit institutions.

[6] An agreement was reached on 12 December 2013 between the European Parliament, Member States and the European Commission on the Bank Recovery and Resolution Directive. The law ensures that failing banks can be wound down in a predictable and efficient way with minimum recourse to public money.

Another important development concerned the launch in November 2013 by the ECB of the comprehensive assessment of significant banks in the euro area as part of the preparatory measures in anticipation of the SSM. This assessment aims to enhance the transparency of the balance sheets of euro area significant banks, and in so doing, to trigger balance sheet repair when necessary. This would also contribute to the strengthening of confidence in these banks.

The assessment will consist of three elements. A supervisory risk assessment will be undertaken to review, quantitatively and qualitatively, key risks, including liquidity, leverage and funding. Furthermore, an asset quality review (AQR) will also be carried out, followed by stress tests, to examine the resilience of banks' balance sheet to adverse scenarios. The tests will be held in conjunction with the European Banking Authority (EBA) and are designed to ensure consistency and comparability of outcomes across all banks in EU Member States. The tests will be based on a common methodology and scenarios, and accompanied by a consistent disclosure of results (see Box 2).

BOX 2: DEVELOPMENTS IN THE ASSET QUALITY REVIEW AND STRESS TESTS

The SSM is one of the main building blocks of the European Banking Union and establishes a new centralised system of supervision of banks. This mechanism involves a transfer of bank supervisory powers from national competent authorities (NCA) to the ECB. The latter shall be the single supervisor as from November 2014 and shall conduct supervision in cooperation with the NCAs of members of the Eurosystem and those of other Member States wishing to participate in the SSM.[1] The European Council has adopted a number of legal acts and the ECB published various informative and consultative documents required for the establishment of the SSM, including the SSM Quarterly Reports and the AQR – Phase 2 Manual. The framework for cooperation within the SSM between the ECB and NCAs is governed by the SSM Framework Regulation.

Comprehensive Assessment

A crucial element in the preparation for the SSM is the ECB Comprehensive Assessment. The assessment, which commenced in November 2013 and is planned to be completed in 12 months, aims to foster greater transparency and clarity in the balance sheets of banks subject to direct ECB supervision. The exercise has three main goals:

1) *transparency*, to enhance the quality of information available about the state of health of banks;
2) *repair*, to identify and implement the necessary corrective actions if required;
3) *confidence building*, to assure all stakeholders that banks are fundamentally sound and trustworthy.

According to the list published by the ECB in February 2014, 128 out of 6,000 euro area banks (accounting for approximately 85% of bank assets in the euro area) are subject to the Comprehensive Assessment. On 26 June 2014, the ECB published the list of banks, which, on the basis of established criteria, namely balance sheet size as at December 2013, have been considered as significant and therefore shall be directly supervised by the ECB. The selected domestic credit institutions, which are also subject to the Comprehensive Assessment include Bank of Valletta plc, HSBC Bank Malta plc and Deutsche Bank (Malta) Ltd.[2,3] A final list of banks subject to the direct supervision of the ECB is expected to be drawn up by September 2014.

The Comprehensive Assessment essentially consists of:

1) a supervisory risk assessment;
2) an asset quality review;
3) a stress test.

[1] NCA of countries whose currency is the euro and also of EU countries whose currency is not the euro but which would have established a close cooperation with the ECB.
[2] http://www.ecb.europa.eu/ssm/pdf/SSM-listofdirectlysupervisedinstitutions.en.pdf?
[3] http://www.ecb.europa.eu/pub/pdf/other/en_dec_2014_03_fen.pdf?21d953cb19106056a509a22888c646a8

1. Supervisory Risk Assessment

This assessment assesses a bank's intrinsic risk profile, its position in relation to its peers and its vulnerability to a number of factors. It also addresses key risks in the banks' balance sheets, including liquidity, leverage and funding risks. The new risk assessment system will be a key tool used by the SSM as from November 2014.

2. Asset Quality Review

The AQR examines the asset side of banks' balance sheets as at 31 December 2013. This assessment is broad and inclusive, focusing on credit and market exposures, on and off-balance sheet positions, as well as domestic and non-domestic exposures. All asset classes, including non-performing loans, restructured loans and sovereign exposures are examined in three phases. A selection of the significant banks' loan portfolio has been made during the first phase, in order to ensure that exposures with the highest risk are subject to an in-depth review.

The second phase involves data integrity validation, sampling, on-site reviews of selected files, collateral valuation and the re-calculation of provisions and risk-weighted assets. On-site work of the AQR execution phase (Phase 2) commenced in February 2014. During March 2014, an AQR Manual containing details on the specific methodology was published by the ECB and the first of ten work blocks (Processes, Policies and Accounting Review) has been completed.[4] The creation of "loan tapes" by banks, which include basic account information required for the selection of samples for the credit file review and collective provisioning analysis, was subsequently concluded in April. NCA teams (together with members of engaged independent audit firms) are currently carrying out a detailed credit file review to highlight possible misclassification and under/over-provisioning of sampled exposures for each participating bank. The results are finally used to obtain an AQR-adjusted Core Tier 1 capital (CET1%) calculation. This Phase 2 of the AQR runs until August. The third phase involves a consistency exercise to ensure the comparability of results across all portfolios for all significant banks.

The mobilisation of project structures and relevant resources at domestic level have been finalised in time for the start of the execution phase of the AQR as shown below:

1) **Help desks** have been set up to facilitate data collections.
2) Country teams consisting of ECB experts have been established to provide a direct link between the ECB's central project management office and those of NCAs, as well as with teams working on the AQR implementation in individual Member States.
3) **National project management offices (PMO)** have been set up to carry out the execution of the exercise at national level.
4) **National Steering Committees (NSC)** - The project management offices are in turn overseen by NSCs. The local NSC has been established by the MFSA, as the NCA, and is chaired by the Chairman of the Authority. The other members of the NSC include the Governor of the Central Bank of Malta, together with other officials from the MFSA and the Central Bank of Malta.

In terms of requirements established by the ECB for the AQR, NCAs have concluded the procurement of third parties, such as external consultants and audit firms, to support the process and provide additional transparency. Reputable audit firms have been engaged domestically to support the second phase of the AQR.

[4] http://www.ecb.europa.eu/pub/pdf/other/assetqualityreviewphase2manual201403en.pdf?e8cc41ce0e4ee40222cbe148574e4af7

3. Stress Test

The EU-wide stress test is coordinated by the EBA, in collaboration with the ECB and the European Systemic Risk Board (ESRB). The test applies a common methodology, developed by the EBA and adopted by all EU supervisory authorities, which aims to ensure that all banks are assessed on the basis of common assumptions, definitions and approaches, thereby ensuring comparability of results across the European Union. The stress test is run against two scenarios spread over three years: the baseline scenario provided by the European Commission (EC), and the adverse macro-scenario, which has been developed by the ESRB in close collaboration with the ECB and EBA.

The common methodology and underlying assumptions cover a wide range of risks, including credit and market risks, exposures towards securitisation, and sovereign and funding risks. The methodology is restrictive and rests on a number of key constraints, including a static balance sheet assumption, prescribed approaches to market risk and securitisation, and a series of caps and floors on net interest income, risk weighted assets (RWA) and net trading income. Other key methodological components include:

1) a sovereign shock that impacts banks' balance sheet, including exposures held in the available-for-sale (AFS) portfolio via the internationally agreed gradual phase-out of prudential filters;
2) a shock to banks' funding costs that pass through to the asset and liability side in a conservative asymmetric fashion.

The adverse macro-scenario, designed by the ESRB, reflects systemic risks which represent the current most pertinent threats to the stability of the EU banking sector. More specifically, such threats include:

1) an increase in global bond yields amplified by an abrupt reversal in risk assessment, especially towards emerging market economies;
2) a further deterioration of credit quality in countries with weak demand;
3) stalling policy reforms jeopardising confidence in the sustainability of public finances;
4) the lack of necessary bank balance sheet repair to maintain affordable market funding.

The negative impact of the shocks, which also include stress in the commercial real estate sector, as well as a foreign exchange shock in Central and Eastern Europe, is substantially global. In the European Union, the scenario leads to an overall deviation of EU GDP from its baseline level of -2.2% in 2014, -5.6% in 2015, and -7.0% in 2016. The EU unemployment rate is higher than its baseline level by 0.6 percentage point in 2014, 1.9 percentage points in 2015 and 2.9 percentage points in 2016. For most advanced economies, including Japan and the United States, the scenario results in a negative response of GDP ranging between 5% and 6% in cumulative terms over the baseline.

The EBA is responsible for coordinating the exercise in cooperation with the ECB (in the case of SSM countries), and also for ensuring effective cooperation between home and host supervisory authorities. The EBA therefore acts as a data hub for the extensive transparency of the results of the exercise. On the other hand, NCAs bear the responsibility for overseeing the exercise with the selected banks, checking the quality of results, and identifying and implementing any necessary supervisory reaction measures. At domestic level, the MFSA is conducting the exercise with the contribution of the Central Bank of Malta, whilst a consultancy firm has been engaged to provide the domestic PMO with necessary support.

Quality assurance process

Since the comprehensive assessment is conducted across various Member States, quality assurance measures have been put in place to:

1) ensure a consistent level playing field for banks, irrespective of their location;
2) safeguard the integrity and comparability of the results of the assessment.

For this reason, quality assurance and technical assistance teams, as well as bank inspection teams, have been set up.

Capital Thresholds

The outcome of the comprehensive assessment shall be assessed against set capital thresholds. The benchmark capital threshold for the AQR and the baseline scenario of the stress test is 8% Common Equity Tier 1 (CET1) capital, whereas the threshold for the adverse scenario of the stress test is set at 5.5% CET 1 capital. If banks fail to meet the set thresholds, remedial action would need to be taken. Capital plans would need to be submitted to the ECB shortly after publication of the results; any capital shortfalls relative to the 8% threshold would need to be met within six months whilst shortfalls with respect to the 5.5% threshold would require capital to be raised within nine months.

Results

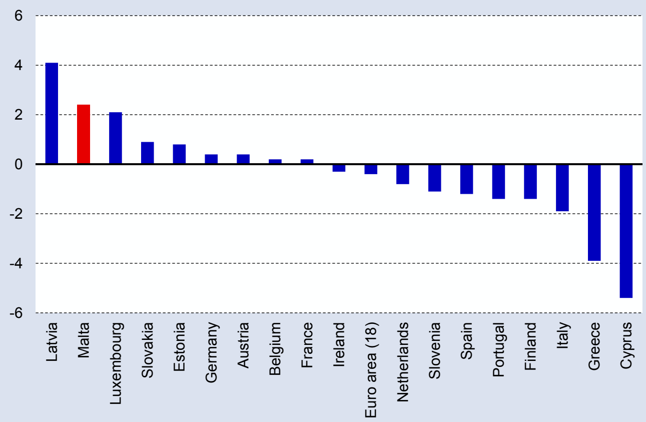
Before assuming its supervisory tasks in November 2014, the ECB shall conclude the comprehensive assessment by providing an aggregate disclosure of the outcomes, at country and bank level, together with any recommendations for supervisory measures. The results of the comprehensive assessment, incorporating the joint results of both the AQR and the stress test, shall be published in October 2014.

This exercise shall contribute further to the soundness of significant banks by cleaning up their balance sheets and enhancing their resilience in the face of adverse shocks.

2.2 The domestic environment

Economic activity in Malta picked up strongly, with real GDP growing by 2.4% in 2013 compared with 0.6% a year earlier. Malta recorded the second largest rate of economic growth in the euro area (see Chart 2.6). The expansion of the Maltese economy was driven by domestic demand, primarily by higher accumulation of inventories, which, however, includes a significant statistical discrepancy element, while gross fixed capital formation partly offset this increase

Chart 2.6
GDP GROWTH RATES (2013)
(per cent)



Sources: European Commission; Central Bank of Malta.

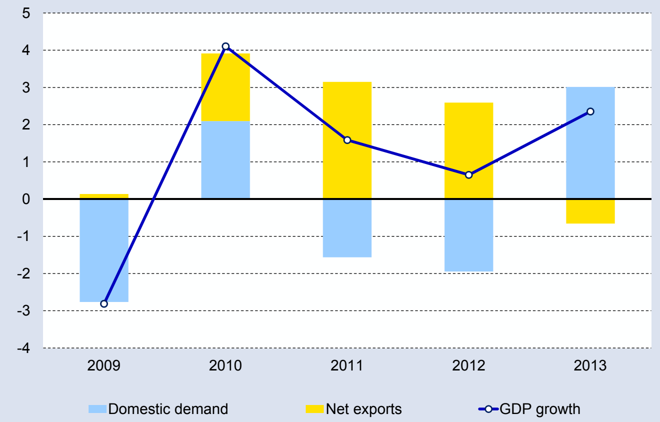
(see Chart 2.7). Growth in private consumption expenditure resumed while government consumption expenditure dropped marginally during the year. Meanwhile, exports dropped at a faster rate than imports and hence the contribution of net exports to GDP growth was 0.7 percentage point lower. Still, net exports remained positive for the third consecutive year. Meanwhile, employment continued to grow at a healthy pace of 3.1% and the unemployment rate remained practically unchanged during the year at 6.5% (see Chart 2.8). This was among the lowest across euro area countries, which, on average, increased by 0.7 percentage point to 12%. Meanwhile, compensation of employees rose by 4.3%, while the inflation rate stood at 1.0%, down from 3.2% a year ago and lower than the 1.4% reported for the euro area in 2013.

The diverging performance of economic sectors persisted throughout the year, with positive developments in most high value added industries partly offset by weaker activity in manufacturing and wholesale sectors, and continued subdued activity in construction and real estate (see Section 3.1.1).

The EC's seasonally-adjusted economic sentiment indicator for Malta improved throughout 2013, reaching 110.2, a level last seen in 2010 and comfortably exceeding the 100 benchmark. At a disaggregated level, the seasonally adjusted consumer, industry, retail and construction confidence indicators for Malta all improved throughout the year.

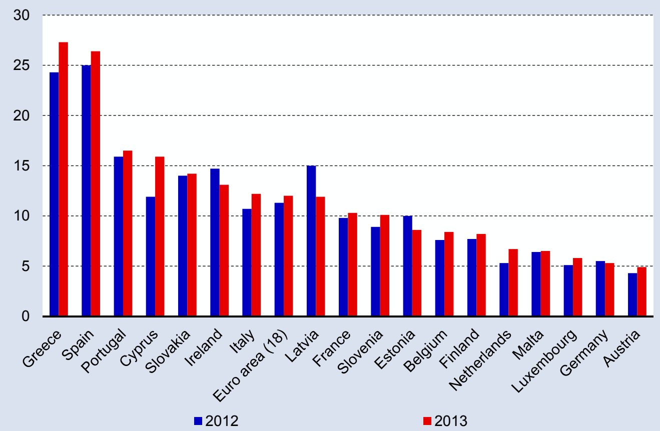
The general government debt increased as a percentage of GDP during the year to 73.0% in 2013 from 70.8% in 2012 (see Chart 2.9). Meanwhile, the euro area average rose by 2.3 percentage points to 95.0%. The deficit figure was

Chart 2.7
CONTRIBUTION TO GDP GROWTH
(percentage points; per cent)



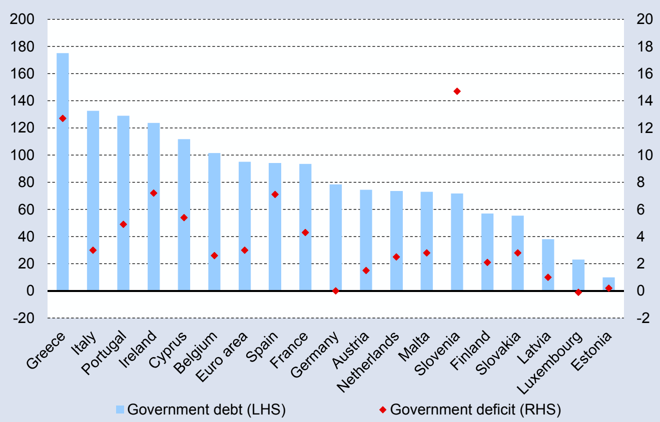
Source: NSO.

Chart 2.8
UNEMPLOYMENT RATES
(per cent)



Source: European Commission.

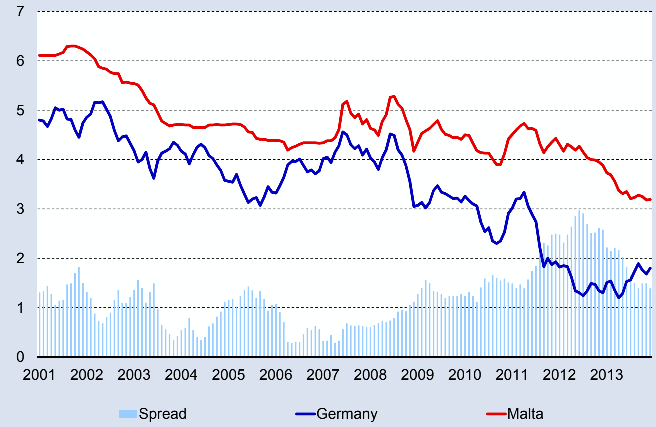
Chart 2.9
DEFICIT AND DEBT-TO-GDP RATIO OF EURO AREA COUNTRIES (2013)
(per cent)



Note: Positive RHS figures indicate a deficit, while negative RHS figures indicate a surplus.
Sources: European Commission; Central Bank of Malta.

estimated at 2.8% of GDP, down from 3.3% in 2012, and slightly below the euro area average of 3.0%.

Chart 2.10
TEN YEAR GOVERNMENT BOND YIELDS
(per cent)



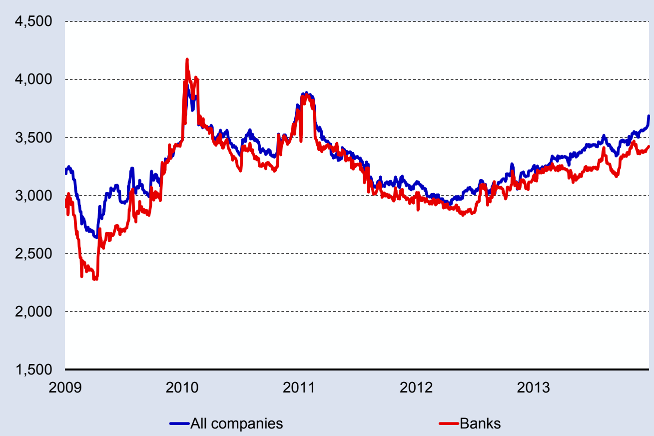
Sources: ECB and Central Bank of Malta.

In September 2013 Fitch downgraded Malta's sovereign debt credit rating from A+ to A, bringing its assessment more in line with those of S&P and Moody's.[7] This notwithstanding, the ten-year government bond yield dropped further in 2013 to the lowest level since euro adoption (see Chart 2.10). The spread vis-à-vis the German bund of similar tenor also narrowed as the bund experienced a marginal increase in its yield. Demand for domestic government paper remained strong, with all new issues being oversubscribed.

Evidence on competitiveness was mixed. The rise in employment income mentioned earlier, in conjunction with a drop in productivity, resulted in an increase of 1.4% in unit labour costs in Malta compared with an increase of 1.1% reported for the euro area. Concurrently, Malta's Harmonised Competitiveness Indicators (HCI) increased by 3.2%, largely owing to the appreciation of the euro. Meanwhile, the euro area's HCI rose by 5.4%. On the other hand, the current account balance remained in surplus for the second year running, following almost a decade of persistent deficits.

The domestic equity market also extended its recovery during 2013, with the Malta Stock Exchange (MSE) Index increasing by 14.8% (see Chart 2.11). This was accompanied by a surge in trading activity on the local equity market, which rose by more than half, with approximately €53 million worth of trades reported over the year. Most listed companies saw their market capitalisation increase in 2013, with only four equities reporting a reduction in their respective market capitalisation. Such drops related to the non-bank corporate sector, as the banking component of the MSE Index increased by 9.9%. The largest gains were reported by IT companies, which largely reflected announcements of a number of new international contracts. Firms in transport, storage and communication sectors also reported double-digit gains. The banking sector remained the largest sector in the equity market, accounting for 54% of overall market capitalisation.

Chart 2.11
MALTA STOCK EXCHANGE INDEX



Sources: MSE and Central Bank of Malta calculations.

In contrast, the corporate bond market saw a drop in trading activity by about a third to €33.4 million. Trading activity in government bonds increased by almost 20%, with government paper continuing

[7] Moody's downgraded Malta's government debt in February 2012 to A3. The S&P downgrade in January 2013 reduced the rating to BBB+.

to account for the bulk of trading on the MSE – 56% as at the end of 2013. The rest is almost equally divided between banks and other corporates.

Meanwhile, the Central Bank of Malta continued to exercise its oversight mandate over the Payment and Securities Settlement Systems in Malta. These systems maintained a high level of efficiency and a smooth transfer of funds and clearance of securities was reported. Credit institutions listed as direct participants of TARGET2 also increased the value of payments by more than a quarter. Furthermore, the Central Bank of Malta conducted an assessment of MaltaClear, its bilateral link with Clearstream Frankfurt and its relayed link involving Clearstream Luxembourg, which resulted in their eligibility for use in Eurosystem credit operations.

Looking ahead, the pace of economic growth is expected to be maintained, with GDP forecast to grow by 2.3% in 2014. This is due to an expected pick-up in domestic demand, with private consumption and gross fixed capital formation projected to increase by 2.2% and 3.3%, respectively. Meanwhile, the inflation rate, based on the Harmonised Index of Consumer Prices, is forecast to edge up to 1.1% in 2014.

3. FINANCIAL STABILITY CONDITIONS

This Chapter reviews the stability of the domestic financial system as reflected by activities of core domestic banks. Section 3.1 examines developments in credit risk where the corporate and household sectors are concerned. Section 3.2 describes the core domestic banks' main asset holdings and potential financial stability risks arising thereof. Section 3.3 explores core domestic banks' funding sources.

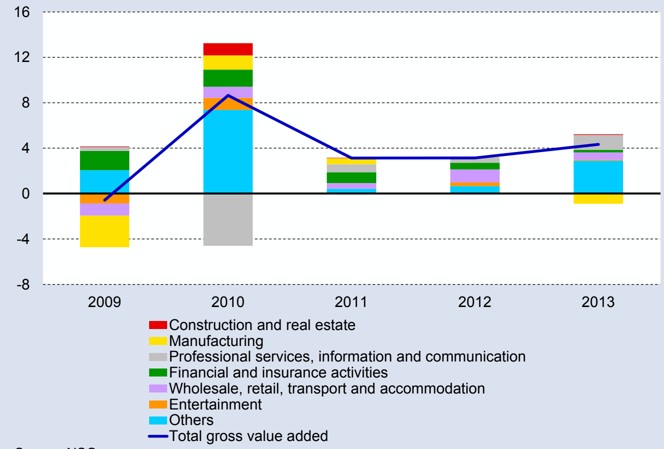
During the year, non-performing loans (NPL) increased, though banks responded to this development by raising their specific provisioning levels. Furthermore, the authorities took measures, through regulatory changes, to raise banks' capital buffers depending on their NPL levels. Banks' main foreign holdings remained predominantly held in financial assets issued by highly rated countries, with sovereign holdings mainly held in domestic government paper. Exposures to stressed countries remained low and the core domestic banks' funding position remained healthy, with customer deposits increasing further. Ample liquidity arising from further increases in retail deposits led to an additional reduction in the share of wholesale and Eurosystem funding during the year. Overall, the resilience of the banking system improved.

3.1 Developments in corporate and household sectors

3.1.1 The corporate sector

Non-financial corporations reported higher profits during 2013, up by 6.1% over the previous year.[1] The increase was characterised by heterogeneity across sectors. Chart 3.1 illustrates the varying contributions of economic sectors to gross value added (GVA).[2]

Chart 3.1
CONTRIBUTION TO GROWTH IN GROSS VALUE ADDED
(per cent)



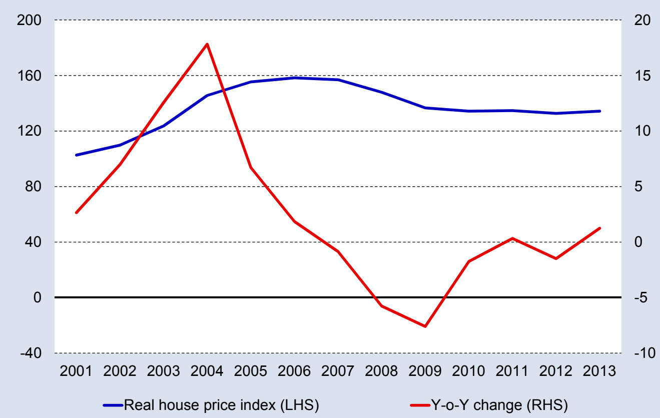
Source: NSO.

Construction and real estate

In line with continued subdued conditions in the property market, the operating surplus of firms in construction continued on a downward path, though firms in real estate sectors posted higher gains during 2013. Consequently, together these sectors' contribution to GVA was negligible.

Indicative property prices, as compiled by the Central Bank of Malta in its Advertised Property Price Index, remained relatively unchanged in real terms during 2013 (see Chart 3.2). In nominal terms these increased by 2.1% during 2013, which remains modest when compared with increases experienced up to 2006.

Chart 3.2
DEVELOPMENTS IN REAL HOUSE PRICES



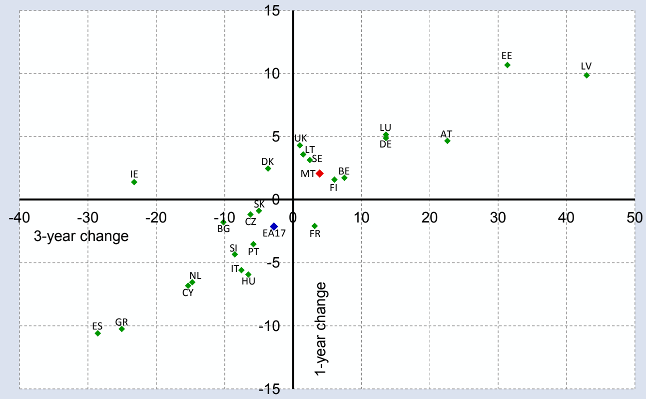
Note: Nominal house prices are deflated using the household consumption deflator.
Source: Central Bank of Malta.

[1] Source: NSO.
[2] Compensation to employees, which is the other major component of GVA, increased by 4.3%.

Across the European Union, real estate market conditions were diverse, with some countries reporting significant increases in nominal house prices during the previous three years, while others experienced persistent depressed conditions (see Chart 3.3). During 2013, most countries reported a moderation in house price changes. The average nominal residential property prices for the euro area 17 countries dropped slightly, while Malta's real estate market conditions remained quite stable over the previous three years.

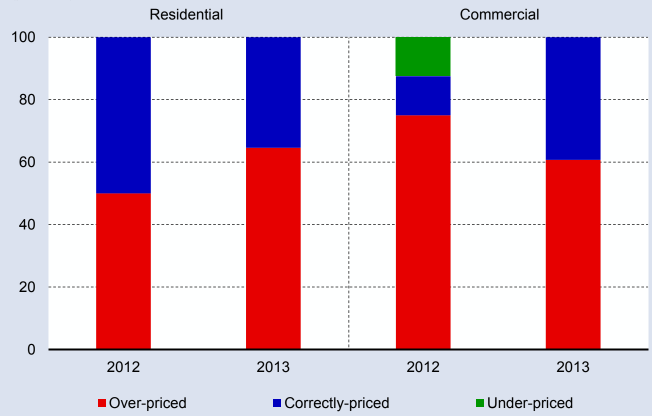
Respondents to the Real Estate Market Survey indicated that the volume of both residential and commercial property sales during 2013 remained relatively stable.[3] In 2013 over 60% of respondents perceived that residential property prices were overpriced, increasing from 50% in 2012, while the rest perceived property to be correctly priced (see Chart 3.4). Similarly, in 2013 over 60% of respondents answered that commercial property was overpriced, while the rest were of the view that they are correctly priced. This contrasted somewhat with responses in 2012 when 12.5% of respondents perceived commercial property prices to be under priced, 75% perceived such prices to be over priced while the remainder considered commercial properties to be correctly priced.

Chart 3.3
CHANGE IN NOMINAL RESIDENTIAL PROPERTY PRICES (2013)
(per cent)



Data refer to total dwellings in all countries (national differences may exist).
Data for CZ and HU refer to 2012 these being the latest data 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 Real Estate Market Surveys.

Additionally, as in the case of other euro area countries, the Construction Confidence Index for Malta (published by the European Commission) remained in negative territory throughout 2013. Furthermore, the number of units for which a permit was issued by the Malta Environment and Planning Authority (MEPA), a leading indicator of future activity, fell by 11.7% in 2013 to 2705 units, reaching its lowest level in at least a decade. The drop reflected lower unit permits for apartments, reaching a fifth of those issued in 2007, a time when property prices were booming. The outlook remains unclear given the slower growth in mortgages, the drop in outstanding credit to the construction sector, as well as the uncertain economic outlook overseas, which has a negative impact on foreign demand at the high-end market. However, in an attempt to revive the market, the Government recently instituted new measures aimed particularly at first-time buyers and foreign buyers.

[3] The Real Estate Market Survey (REMS) is conducted biannually by the Bank among a sample of real estate agents.

In the light of continued weakness in construction activity, core domestic banks maintained their cautious approach to lending to these sectors, resulting in a further contraction in lending to the construction sector during the year. The exposure of core domestic banks to the construction sector indeed declined further, accounting for 22.1% of corporate loans at the end of 2013, down from 22.5% in 2012. However, lending to the real estate sector amounted to 9.5%, up from 8.9% a year earlier.

Other non-financial corporate sectors

A number of industries continued to contribute positively to GVA. The transportation and storage sectors registered a 27.6% increase in their operating surplus, mainly driven by warehousing and support activities for transportation and water transport. Firms in accommodation and food services sectors also reported higher operating surplus, up by 22.9%, with the increase mainly underpinned by accommodation services. This result is further supported by findings in the Malta Hotels and Restaurant Association Survey, which indicated that during 2013 all top three hotel categories (3-star, 4-star and 5-star) registered improvements in gross operating profit per available room, despite higher overheads reported by the 3-star to 5-star establishments. This improvement mainly reflected higher turnover as tourism business remained buoyant. Indeed, departing tourists in 2013 increased by 9.6% compared with 2012, with tourist expenditure rising by 8.6%. In addition, the information and communication sectors reported a 17.4% increase in operating surplus, with the biggest rise occurring in computer programming and broadcasting activities, and in communications sub-sectors. Also, the operating surplus of professional, scientific and technical activities increased by 12.4%, while administrative and support service activities registered an improvement of 10.4% in their operating surplus.

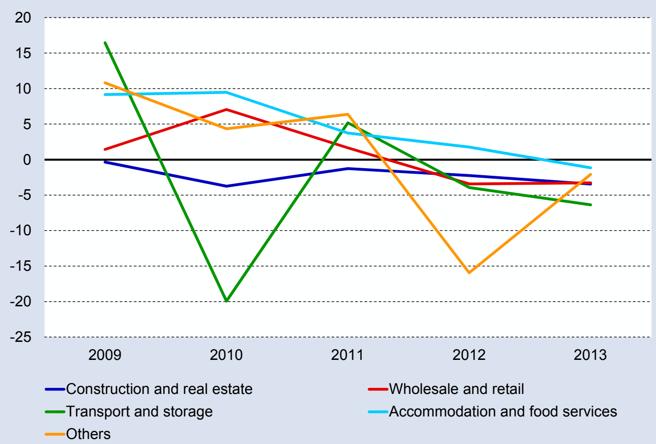
At the same time, the performance of firms in the electricity, gas, steam and air conditioning supply industry improved over the previous year, with losses declining significantly in 2013.

Operating surplus in manufacturing firms continued to deteriorate during 2013, down by 26.8%. This is also evidenced in the Index of Industrial Production, which on average fell by 4.3% during 2013.[4] The wholesale and retail sector also recorded a drop in profits.

Corporate indebtedness and concentration

During 2013 lending to the resident corporate sector by core domestic banks declined by 3%, though this drop was smaller than reported in the previous year.[5] Results of the Bank Lending Survey (BLS) indicate that this slowdown was primarily demand-driven (refer to Box 3). Nevertheless, specific lending programmes with risk-sharing characteristics (e.g. JEREMIE programme) have had a very positive response. At the same time, banks remained cautious and maintained tight credit standards, particularly towards firms in construction and real estate. Lending to the wholesale and retail, transport and storage, accommodation and food service sectors also declined (see Chart 3.5). Meanwhile, at 5.1%, the weighted average interest rate on lending to the resident corporate sector remained largely in line with that in 2012.

Chart 3.5
CORPORATE BANK LENDING - CORE DOMESTIC BANKS
(percentage change)



Source: Central Bank of Malta.

[4] The index of Industrial Production, which is compiled by the National Statistics Office, describes the economic cycles of the manufacturing industry.

[5] A similar pattern was observed in lending by the total banking system, which fell by 4.1% during 2013.

BOX 3: BANK LENDING SURVEY RESULTS

The BLS is mainly designed to collect information on euro area banks' lending behaviour on a quarterly basis.[1] Through this survey, the ECB obtains detailed information on the Eurosystem's financing conditions and consequently supports the Governing Council in its policy-making process. In Malta, four of the five core domestic banks participate in this survey.[2]

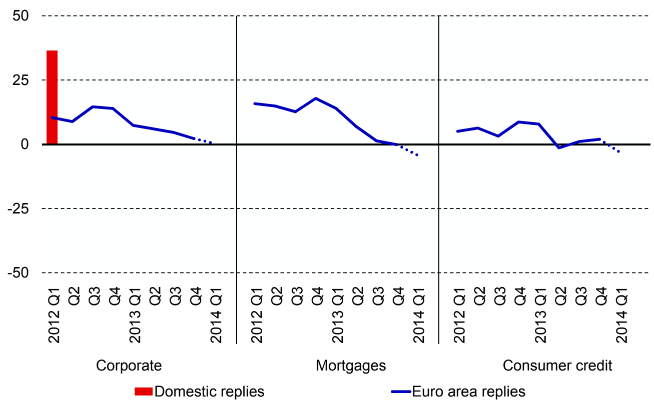
Credit Supply Conditions

Following a tightening in corporate credit standards in early 2012, Maltese BLS banks maintained their credit standards relatively tight in 2013, mainly through wider margins applicable on riskier loans as well as stricter requirements set in loan covenants (see Chart 1). Conversely, in the euro area, the wave of tightening in 2012 levelled off throughout 2013. Furthermore, expectations for the euro area regarding the first quarter of 2014 indicate further easing of corporate credit standards.[3,4]

Unlike the euro area, where a steady decline in net tightening for mortgage credit standards took place, mortgage credit standards in Malta were kept unchanged at tight levels throughout the course of 2013 (see Chart 1). In the euro area, improvements in the macroeconomic outlook, in housing market prospects and households' creditworthiness all exerted an easing influence on mortgage credit standards.

With regard to standards on consumer loans, Maltese BLS banks eased these standards in the last quarter of 2011 and since then, these have been kept generally unchanged. This trend diverges from what was reported by other euro area banks, which reported a lower level of net tightening compared with 2012 (see Chart 1). However, towards the latter half of 2013, euro area respondents tightened somewhat their standards owing to higher risk perceptions and balance sheet constraints. Nevertheless, during the first three months of 2014, euro area banks have been anticipating another round of easing in standards. In Malta, however, consumer credit standards have been anticipated to remain unchanged during the first quarter of 2014.

Chart 1
CREDIT STANDARDS
(+ indicates net tightening / - indicates net easing)



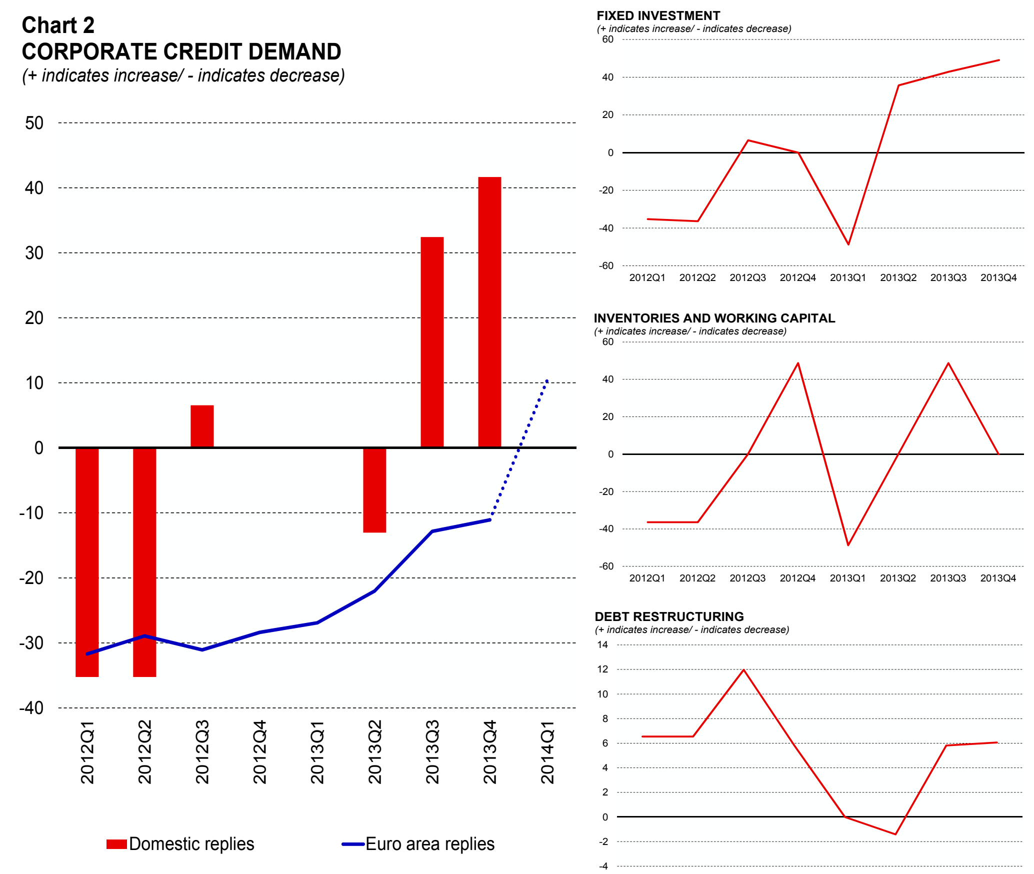
Note: 2014Q1 information relate to expectations.
Domestic mortgage and consumer credit standards were unchanged.
Sources: ECB and Central Bank of Malta calculations.

Credit Demand Conditions

Following a dip in the second quarter of 2013, Maltese BLS respondents reported an increase in corporate credit demand owing to higher fixed investment and greater debt restructuring

[1] The bank lending survey is addressed to senior loan officers of a representative sample of euro area banks.
[2] Net percentages are used to analyse the trend estimates. Data is published on the ECB's Statistical Data Warehouse.
[3] http://www.ecb.europa.eu/stats/pdf/blssurvey_201401.pdf?791a94b4cc3645e290f37435685dc46b
[4] The sample represents all of the euro area countries, including Malta.

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



Sources: ECB and Central Bank of Malta calculations.

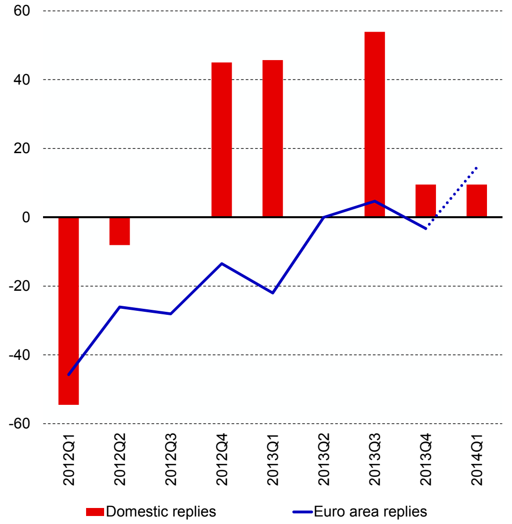
(see Chart 2). Looking forward, in the first three months of 2014, demand has been projected to remain positive and stable.

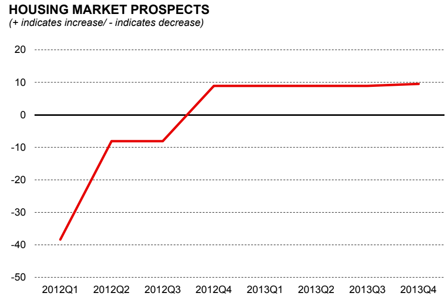
Despite some signs of recovery, corporate credit demand in the euro area remained subdued in 2013. Sluggish loan demand mainly reflected the lack of fixed investment undertaken by euro area enterprises. However, similar to Maltese banks, euro area respondents have been anticipating a pick-up in corporate loan demand for the first quarter of 2014.

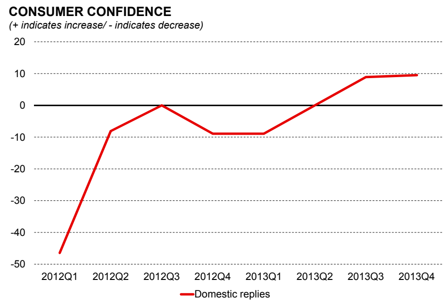
Maltese banks have reported a positive boost in mortgage credit demand in 2013, particularly when compared with 2012 (see Chart 3). To this end, favourable housing market prospects, coupled with positive levels of consumer confidence, have encouraged home loan borrowing. Such positive prospects in mortgage demand are also expected to prevail in 2014 following specific measures to support first-time buyers. On the other hand, euro area home loan demand has predominantly remained negative. The recovery reported in the third quarter of 2013 was short-lived, as in the final three months of the year euro area banks reported a small net decline in demand for mortgages. Looking ahead, encouraging signs of a recovery in mortgage loan demand has been anticipated for the first quarter of 2014 by euro area banks.

According to Maltese respondents, demand for consumer loans remained weak during 2013. Lower spending on consumer goods, coupled with a deterioration in consumer confidence, were the main

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



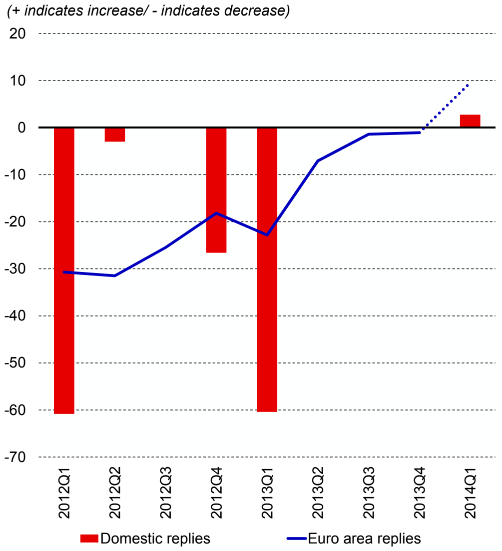


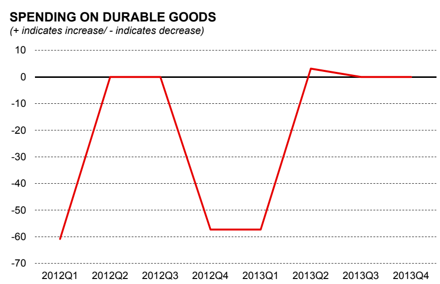


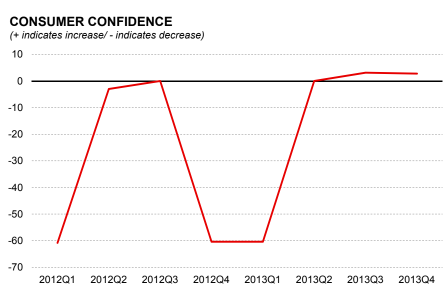
Sources: ECB and Central Bank of Malta calculations.

factors which impinged on consumer credit demand. In the euro area, demand for consumer loans in the first quarter of 2013 declined somewhat, though this showed signs of an incipient recovery owing to a smaller negative impact of household spending on durable goods and consumer confidence. During the third quarter of 2013, consumer credit improved but remained in the negative territory in the euro area. However, a pick-up is expected by both Maltese and euro area banks in the first quarter of 2014 (see Chart 4).

Chart 4
CONSUMER CREDIT DEMAND
(+ indicates increase/ - indicates decrease)







Sources: ECB and Central Bank of Malta calculations.

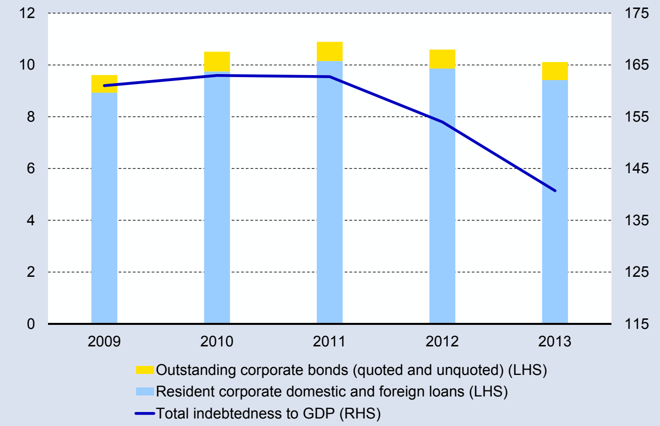
The resident corporate sector also resorted to external funding through the capital market. However, the value of bonds issued by the sector declined by 4.6% in 2013 and by 3% for those bonds listed on the Stock Exchange, mainly reflecting redemptions and reductions reported by firms in construction and accommodation sectors. With regard to bonds issued on the Malta Stock Exchange, three corporations operating in the hotel, automotive and oil and gas industries launched new bonds totalling €48 million during the year, mainly reflecting rollover of debt at lower rates.

Overall corporate indebtedness (which includes bonds, bank credit and funding from non-financial and other stakeholders) dropped to 140.7% of GDP in 2013 from 154.0% in 2012 (see Chart 3.6). This was due to both a drop in resident corporate domestic and foreign loans and, to a lesser extent, to lower outstanding corporate bonds. When considering outstanding corporate bonds and loans granted to the corporate sector by core domestic banks, corporate indebtedness dropped to 65.6% of GDP compared with 70.8% a year earlier. Loans granted by non-core domestic banks to the resident corporate sector amounted to 2.3% of GDP, while lending by international banks to the resident corporate sector was negligible.

Some concentration in the sectoral allocation of loans remained, with 22.1% of resident corporate loans by core domestic banks being granted to the construction sector, albeit down from 22.5% (see Chart 3.7). A total of 19.2% of these loans was granted to the wholesale and retail sector, remaining stable from last year, and 11.5% to the accommodation and food services sector, up from 11.3% in 2012.

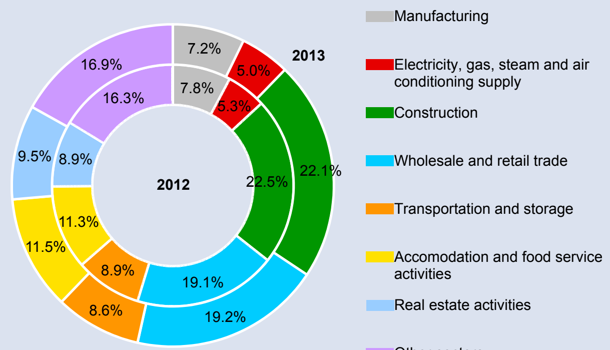
Concentration is also evident given the magnitude of bank credit

Chart 3.6
INDEBTEDNESS OF NON-FINANCIAL CORPORATES
(EUR billions; per cent)



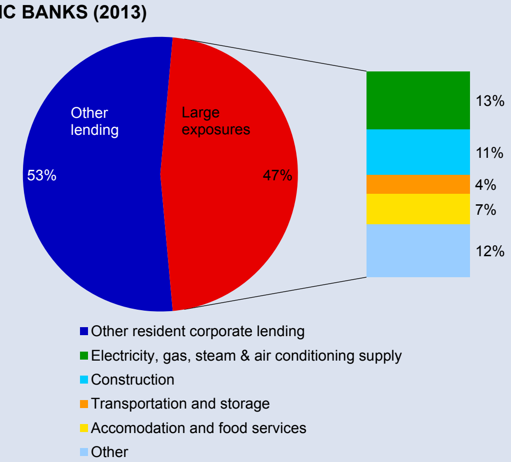
Sources: Central Bank of Malta; NSO.

Chart 3.7
RESIDENT CORPORATE LOANS BY SECTOR - CORE DOMESTIC BANKS



Source: Central Bank of Malta.

Chart 3.8
CONCENTRATION IN RESIDENT CORPORATE LENDING - CORE DOMESTIC BANKS (2013)
(per cent)



Source: Central Bank of Malta.

extended to a number of large borrowers operating within specific industries.[6] These borrowers include firms in construction, transport, energy, accommodation and food service sectors, and accounted for 47% of total corporate credit (see Chart 3.8). A degree of concentration is however inevitable given the size and relatively narrow base of the economy.

3.1.2 The household sector

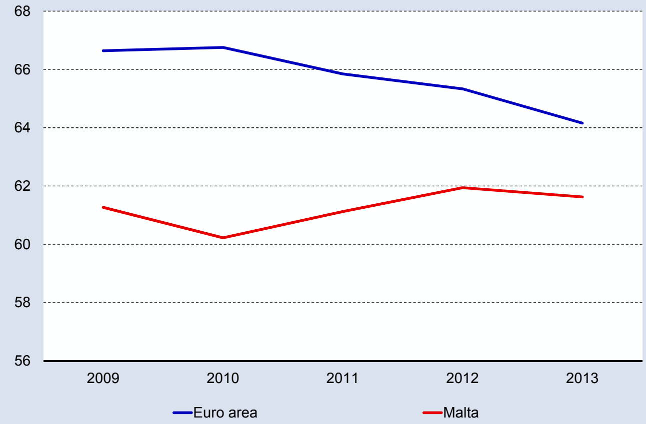
Household indebtedness

During 2013 growth in households' resident loans slowed down to 4.9% from 5.2% a year earlier, in part reflecting developments in private consumption, which increased only marginally. Consumer credit contracted by 1.2% during 2013 to €678.4 million. On the other hand, mortgage lending rose by 6.3% in 2013 to €3.3 billion, albeit still below its five-year average growth of 8.1%. Over a year, household debt relative to GDP remained predominantly stable at 61.6%, and lower than the average for the euro area, which stood at 64.2% (see Chart 3.9).[7]

Households' cost of borrowing dropped by 0.2 percentage point to 3.9%, entirely attributable to a lower weighted average interest rate on mortgages, which stood at 3.6% in 2013 (see Chart 3.10). In turn, the weighted average interest rate for consumer credit remained unchanged at 5.6%.[8] Consequently, the interest burden as a percentage of compensation of employees dropped to 4.8% in 2013 from 5% in 2012, reflecting the lower cost of debt.

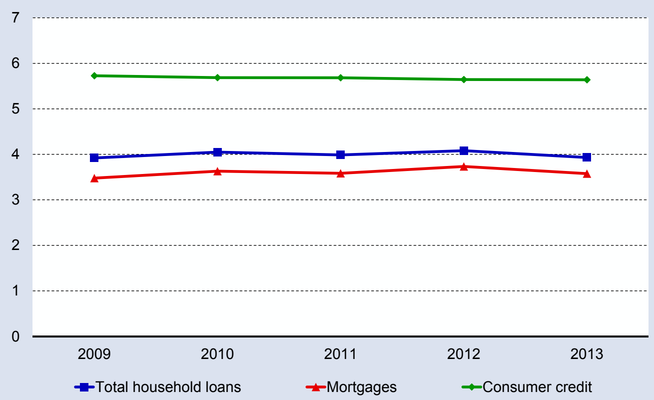
The credit worthiness of resident households was also supported by an increase in their net financial

Chart 3.9
HOUSEHOLD DEBT TO GDP RATIO
(per cent)



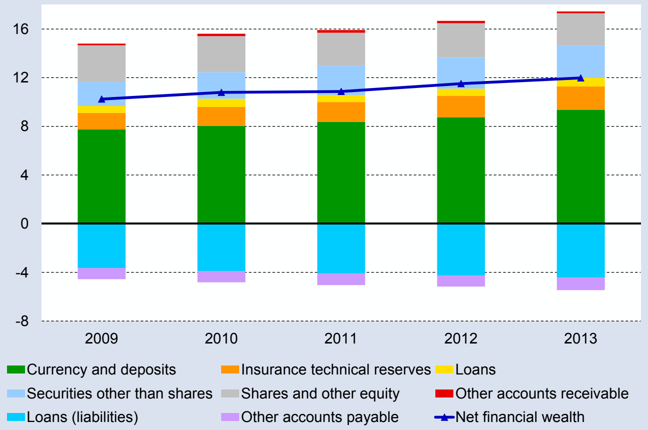
Source: SDW.

Chart 3.10
WEIGHTED AVERAGE INTEREST RATES ON RESIDENT HOUSEHOLD LOANS - CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

Chart 3.11
NET HOUSEHOLD FINANCIAL WEALTH
(EUR billions)



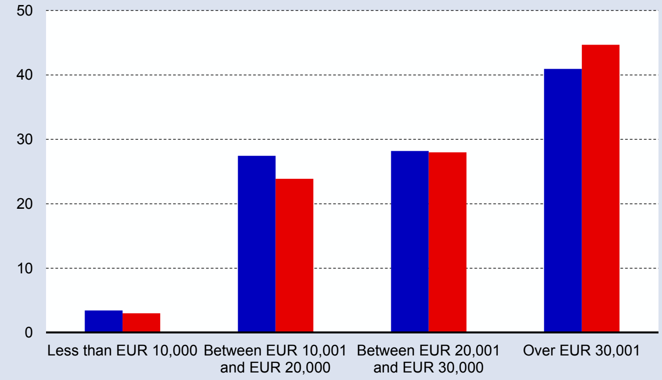
Source: Central Bank of Malta.

[6] A loan is classified as a large exposure when it accounts for more than 10% of Tier 1 capital of a particular bank.
[7] Source: ECB *Financial Stability Report*, November 2013.
[8] The weighted average interest rate on consumer credit also includes credit card debt. However, the latter is a minimal part of consumer credit, thus having a limited impact on the overall weighted average interest rate.

wealth, which rose by 4.1% in 2013 (see Chart 3.11).[9] This improvement mainly reflected higher holdings of deposits.

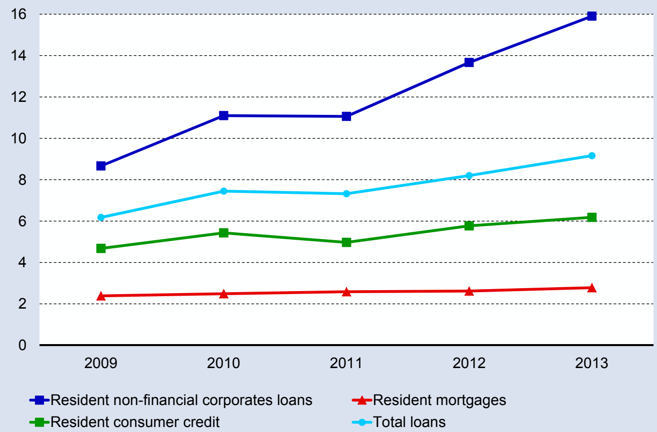
The distribution of household loans by income bracket continued to support a low level of credit risk for mortgaged loans. During 2013 the proportion of loans held by households with an annual income of less than €30,000 dropped when compared with the previous year, with loans granted to households with an income of less than €10,000 per annum accounting for about 3% of the total (see Chart 3.12). About 45% of bank loans were channelled to households with an annual income exceeding €30,000 per annum, increasing somewhat during the year, consistent with the rise in household financial wealth.

Chart 3.12
DISTRIBUTION OF HOUSEHOLD LOANS BACKED BY RESIDENTIAL PROPERTY BY INCOME BRACKET - CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

Chart 3.13
NPL RATIOS - CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

3.1.3 Quality of bank loans

At the end of 2013 the NPL ratio of core domestic banks stood at 9.2%, up from 8.2% in 2012, mainly reflecting a deterioration in the quality of resident corporate loans (see Chart 3.13 and Section 4.3 for data on the actual impairments reported by core domestic banks and the related provisioning).[10,11] Non-resident NPLs remained marginal, amounting to less than 1% of total NPLs reported.

During 2013 resident corporate NPLs, as a proportion of resident corporate lending, increased by 2.2 percentage points to 15.9%, mainly as a result of a 12.8% rise in corporate NPLs. However, the drop in the overall level of corporate lending also contributed marginally to the rise in the ratio. All but one of the core domestic banks reported higher NPLs, spread across all main economic sectors, but especially the construction

[9] The calculation of net financial wealth was revised mainly to include households' investment in foreign securities. Thus, calculations differ from those reported in the 2012 *Report*.

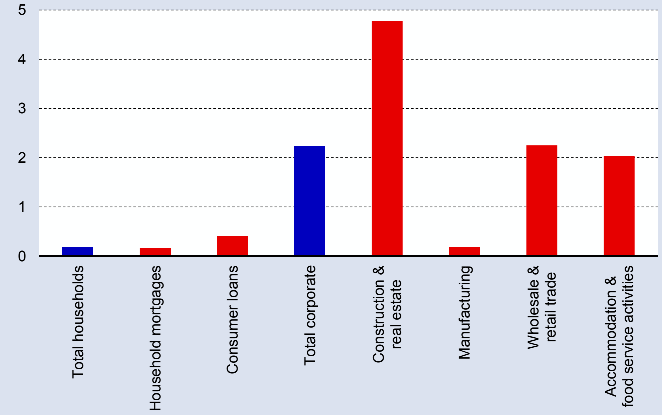
[10] NPLs are defined as loans which are doubtful and irrecoverable. According to Banking Rule BR/09 doubtful loans are credit facilities whose capital and/or interest are overdue by 90 days and over. Such loans also include facilities which, irrespective of the repayment not being overdue by 90 days, are considered by banks as giving rise to doubts regarding their recoverability.

[11] The resident corporate NPL ratio at the end of December 2012, published in the *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. 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. Refer to the *Update of the Report* 2013, p 4.

& real estate sector, and to a lesser extent, the wholesale & retail and accommodation & food service sectors (see Chart 3.14).

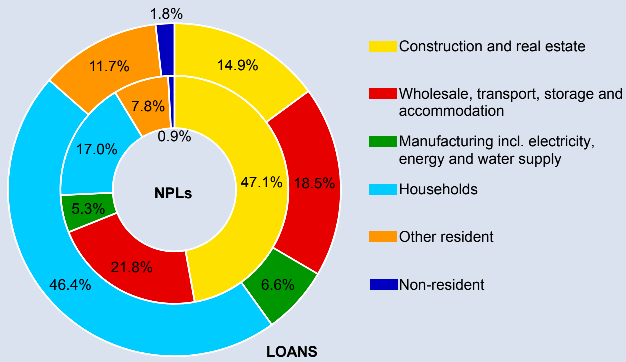
The household loan portfolio deteriorated marginally in 2013, with the resident household NPL ratio increasing to 3.4% from 3.2% a year earlier reflecting a weakening in the quality of both consumer credit and mortgages. The consumer credit NPL ratio increased by 0.4 percentage point to 6.2% and the mortgages NPL ratio increased slightly by 0.2 percentage point to 2.8%. However, the household sector, which accounts for over 46% of total loans, sustained its characteristic of higher quality, accounting for only 17% of total NPLs (see Chart 3.15). The continued increase in net financial wealth, strong employment growth coupled with stable and low unemployment, and the drop in the weighted average interest rate have all contributed to sustain the good quality of this type of asset.

Chart 3.14
CHANGE IN NPL RATIO (2013 COMPARED WITH 2012) - CORE DOMESTIC BANKS
(percentage points)



Source: Central Bank of Malta.

Chart 3.15
SECTORAL ALLOCATION OF LOANS AND NPLs - CORE DOMESTIC BANKS (2013)



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.

3.2 Other asset holdings

3.2.1 Foreign asset holdings[12]

Foreign asset holdings of core domestic banks increased by 2.6% during 2013, ending the year at €2.9 billion, representing 19.4% of total assets. This was propelled by higher holdings of paper of non-euro area countries, which rose by 4% to €1.9 billion, equivalent to 12.4% of total assets. Meanwhile, euro area asset holdings remained relatively stable at €1.1 billion or 7.1% of total assets.[13] The majority of foreign asset holdings are in highly-rated economies, including those of Germany, France, the Netherlands, the United Kingdom, Australia and the United States (see Chart 3.16). Asset holdings in stressed euro area countries accounted for 6.3% (4.9% in 2012) of total foreign asset holdings, or 17.3% of the total euro area asset holdings.[14] The increase mainly reflected higher holdings of securities issued by foreign monetary financial institutions (MFI), particularly intragroup holdings, with sovereign securities declining compared with the previous year. Meanwhile, exposures to emerging markets represent less than 3% of asset holdings.[15]

[12] Foreign asset holdings include all securities held by core domestic banks and placements with banks (loans and deposits) which originate from sovereign entities, MFIs and other non-financial private companies outside Malta.
[13] Euro area asset holdings include securities and placements with banks from euro area countries, but exclude Maltese assets and any holdings with the Central Bank of Malta.
[14] Stressed countries include Cyprus, Greece, Ireland, Italy, Portugal, Slovenia and Spain.
[15] Emerging countries are defined as per lists of emerging markets and developing countries specified by the IMF, FTSE, MSCI, the Economist, S&P, Dow Jones, BBVA and Columbia University EMGB.

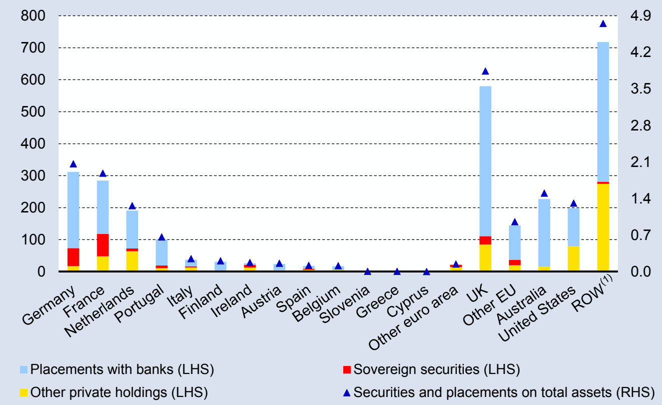
Euro area asset holdings remained stable, as a 31.6% drop in placements with banks was partly offset by a 19.1% increase in securities holdings (see Chart 3.17). Holdings of assets originating from euro area MFIs dropped by 4.4%, but still remain the largest counterparties. Meanwhile, banks reported higher holdings of assets issued by the "other" category, largely representing non-MFI private companies, and by "sovereign" bonds. During 2013 sovereign bond holdings increased by 12.9%, through higher holdings of German, and to a lesser extent, UK paper. However exposures to other euro area sovereigns remained unchanged at 1.1% of total assets. This as banks decreased their holdings in stressed countries by more than 30% to 0.16% of total assets in 2013.

3.2.2 Domestic government paper

During 2013 core domestic banks' holdings of domestic government paper increased by 4.3% to €1.8 billion, equivalent to 11.6% of their total balance sheet size. The increase mainly reflected higher holdings of Treasury bills as the rise in Malta Government Stock (MGS) was only marginal. However, the faster growth in foreign securities holdings led to a 1.8 percentage point drop in the share of domestic government paper, down to 48.2% of the total investment portfolio.

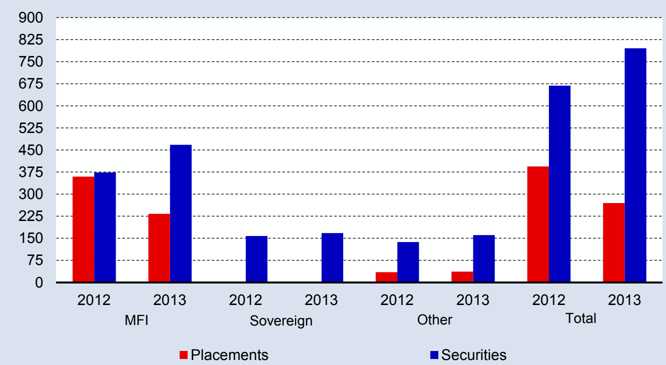
The majority of such holdings are redeemable in the short to medium term, with around €350 million, on average, maturing every year, the bulk of which are held by core domestic banks (see Chart 3.18). However, the rollover risk for MGS remains remote. Indeed, the strong demand for newly-issued MGS persisted in 2013 with an average bid-to-cover ratio of 2.3. Also, in

Chart 3.16
ASSET HOLDINGS OF SELECTED COUNTRIES - CORE DOMESTIC BANKS (2013)
(EUR millions; per cent)



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

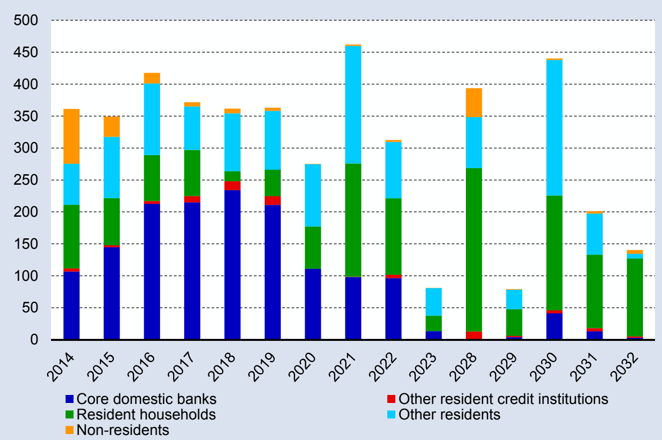
Chart 3.17
EURO AREA HOLDINGS - CORE DOMESTIC BANKS
(EUR millions)



Note: Data excludes Maltese assets and holdings with the Central Bank of Malta. Data on placements includes loans to and deposits with MFIs. "Other" includes private companies excluding MFIs.

Source: Central Bank of Malta.

Chart 3.18
OUTSTANDING MGS BY OWNERSHIP AND REDEMPTION DATE (2013)
(EUR millions)



Sources: MSE and Central Bank of Malta calculations.

December 2013 the third stage of the Three-Year Malta Government Stock Switch Auction Programme was conducted successfully, extending the maturity of €150 million MGS due to mature in 2014. The Treasury has plans to re-launch another switch auction programme during 2014. In addition, non-resident financial investors' participation remained limited, accounting for only 4.7% of the outstanding amount. MGS holders generally adopt a buy-to-hold approach, with the average daily trading in MGS amounting to €2.5 million in 2013, equivalent to 0.06% of the average outstanding amount of MGS in that year.

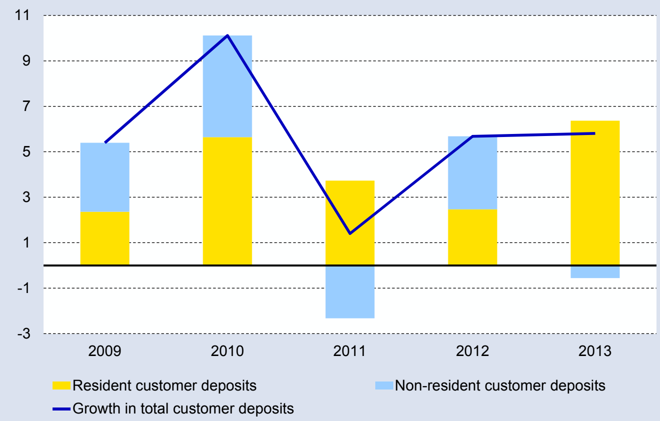
Debt servicing costs declined further during 2013, as evidenced by the ten-year MGS yield, which reached its lowest level during the last decade.

3.3 Funding

3.3.1 Customer deposits

Customer deposits grew by 5.8% during 2013, marginally faster than recorded in 2012 (see Chart 3.19). This led to the core domestic banks' customer base to expand further, rising to 84.7% of total liabilities, which is 2.6 percentage points higher than a year earlier. This resulted in the highest proportion of customer deposits against total liabilities in the last decade. Resident customer deposits rose by 7.7%, with both resident household and corporate deposits contributing to the increase. However, the latter was partly offset by a 3.1% decline in non-resident deposits, following a 20.5% increase in 2012. This category has shown a rather volatile behaviour as seen in Chart 3.19. Nevertheless, the non-resident customer deposits account for only 16.3% of total customer deposits.

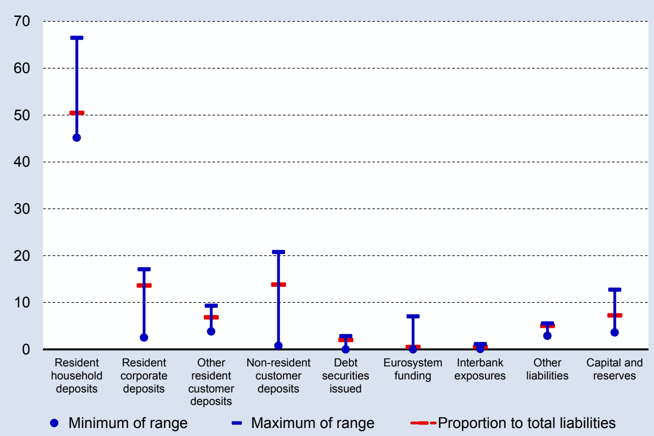
Chart 3.19
CONTRIBUTION TO GROWTH IN CUSTOMER DEPOSITS - CORE DOMESTIC BANKS
(% points; per cent)



Source: Central Bank of Malta.

Resident household deposits went up by 5.9% to account for 59.5% of total customer deposits, equivalent to slightly more than half of total liabilities (see Chart 3.20). The rise in resident household deposits surpassed that recorded in 2012, despite households' increased participation in the capital market. This sustained addition in deposits partly reflects higher employee compensation, which outpaced growth in private consumption. Resident corporate deposits also increased significantly, up by 8.8% during 2013, partly due to the rise in operating surplus coupled with a drop in investment.

Chart 3.20
BANKS' LIABILITY COMPONENTS - CORE DOMESTIC BANKS (2013)
(per cent)



Source: Central Bank of Malta.

The increase in the flow of deposits was recorded despite a further drop in the weighted average interest rate on both euro and foreign currency-denominated deposits, ending 2013 at 1.16% and 0.36%, respectively. Also, these rates remain significantly lower than those offered by non-core domestic banks, which also reported a rise in customer deposits (see Chapter 5). More than 90% of resident customer deposits held by core domestic banks are denominated in euro, which drove the acceleration in these deposits. In the case of non-residents, euro-denominated customer deposits amounted to 56.2% of total non-resident customer deposits, with the rest reflecting other currencies, largely of non-EU Member States.

The inherent preference towards liquid deposits persisted throughout 2013, with the share of savings and current accounts amounting to 57% of total deposits, up from 55.3% in December 2012. Similarly, the share of term deposits with a maturity of less than one year increased by 0.4 percentage point to 36% of total deposits. Meanwhile, longer-term deposits (maturity of more than one year) dropped by 18.7%, thus reducing their share in total deposits to 7%.

3.3.2 Eurosystem and wholesale funding

During 2013 Eurosystem funding dropped by 70.3%, largely reflecting the repayment of most of the three-year long-term refinancing operations. As a result, the proportion of Eurosystem funding to total liabilities dropped to just 0.5% from 1.7% a year earlier. The low utilisation of Eurosystem funding reflects the ample liquidity conditions of core domestic banks. Indeed, as at end-2013, only 0.02% of the core domestic banks' collateral pool was utilised.

Similarly, interbank funding contracted, with its share of total liabilities dropping from 2.1% to 0.5%. This mainly reflected a notable decline in intragroup funding. Debt securities issued by core domestic banks remained stable during 2013, accounting for just 2% of total liabilities.

4. CORE DOMESTIC BANKS: ASSESSMENT OF PERFORMANCE AND RESILIENCE

This Chapter reviews the performance and resilience of core domestic banks in the light of challenges highlighted in Chapter Three. Section 4.1 reviews developments in the core domestic banks' balance sheet, pointing to large increases in holdings of securities, while the size of the loan portfolio was almost unchanged. Section 4.2 describes developments in the banks' profitability, showing lower, but still relatively strong, profits. In turn, Section 4.3 analyses the increases in the loan loss provisions and coverage ratios, and also elaborates on regulatory changes. Section 4.4 explains developments in the core domestic banks' liquidity and Section 4.5 presents an assessment of their strengthened capital positions.

Core domestic banks continued to enhance their resilience, while also further expanding their balance sheets. Capital buffers were strengthened, also backed by positive performance. Liquidity remained ample, supported by higher customer deposits. The banks' overall underlying strength was also reaffirmed by the results of stress tests conducted by the Central Bank of Malta, which are included in Section 4.6.

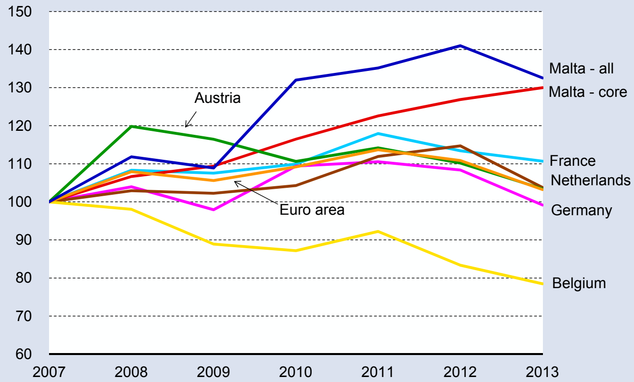
4.1 Balance sheet developments

In 2013 the aggregated balance sheet of core domestic banks increased by 2.5%, despite a contraction in the first half of the year (see Chart 4.1). This growth rate has been decelerating since 2011.

When the remainder of the banking sector, namely the non-core domestic and international banks, is also taken into consideration, the whole banking sector reported a drop of 6.0% in the size of its balance sheet. In the euro area as a whole, the banking sector contracted by 6.9%, mainly reflecting the continued deleveraging process and measures to strengthen capital ratios.

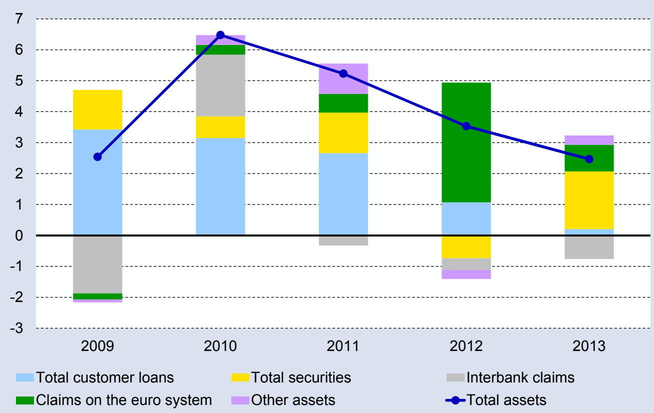
The biggest contributor to the increase in core domestic banks' total assets was the rise in securities holdings, up by 8.1% to €3.6 billion, equivalent to around a quarter of total assets (see Chart 4.2). Holdings of foreign monetary financial institution (MFI) securities rose by 14.4% to €1 billion, amounting to 27.7% of the total investment portfolio (see Chart 4.3). Holdings of foreign corporate securities also rose in 2013, up by 14.4%. Holdings of domestic government paper, which accounted for almost half of the total investment portfolio, went up by 4.3% to almost €1.8 billion.

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



Sources: ECB and Central Bank of Malta.

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



Source: Central Bank of Malta.

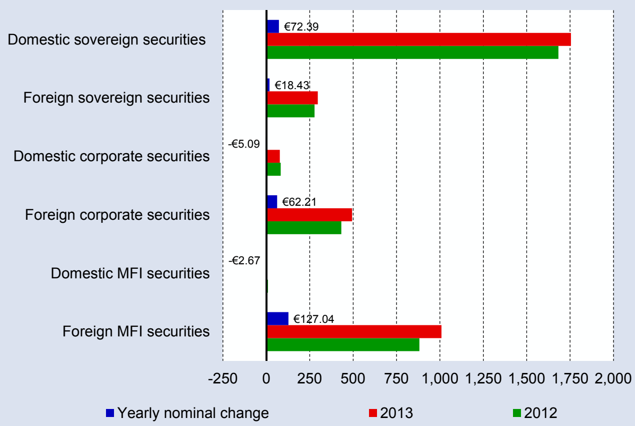
Banks increased once more their preference to hold securities up to maturity, so that the proportion of securities "held to maturity" climbed by 8.6 percentage points to 45.7% of their total securities portfolio. Meanwhile, the share of securities "available for sale" amounted to 44.1%, while securities "designated at inception at fair value through profit and loss" stood at 9.6%, with those held for trading purposes accounting for just 0.6% of the overall portfolio.

Placements with the Central Bank of Malta rose by 14.2% to just over €1 billion, representing 6.8% of total assets. These funds significantly exceeded the minimum reserve requirement, indicating excess liquidity held by core domestic banks. This development, however, is not homogenous across all core domestic banks as some reported lower placements with the Bank.

The loan portfolio increased marginally by 0.4%, even though it continues to be the largest component of core domestic banks' assets, with lending to corporate and household borrowers amounting to 56.3% of total assets (see Chart 4.4). Meanwhile, interbank placements dropped by 10.1%, mainly reflecting lower placements with their respective parent institution.

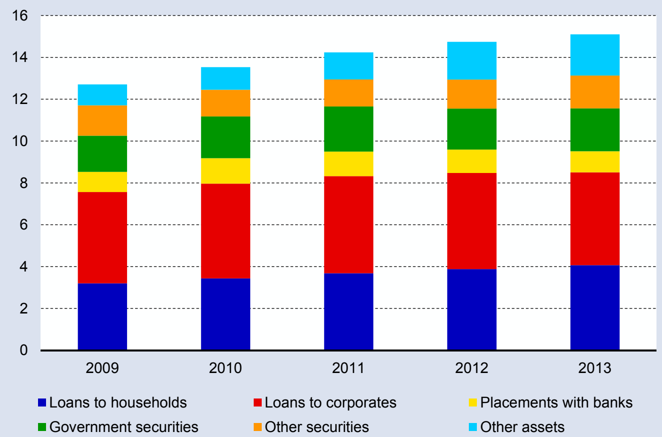
On the liabilities side, customer deposits, which account for 84.7% of core domestic banks' total liabilities, rose by 5.8% (see Section 3.3.1). The increase in deposits, coupled with the marginal rise in customer loans referred to earlier, led to a decline of 3.6 percentage points in the customer loan-to-deposit ratio, to stand at 66.5% in December 2013 (see Chart 4.5). This is significantly lower than the euro area average of 105.8%, which was down by 4.7 percentage points on the previous year.

Chart 4.3
SECURITIES PORTFOLIO - CORE DOMESTIC BANKS
(EUR millions)



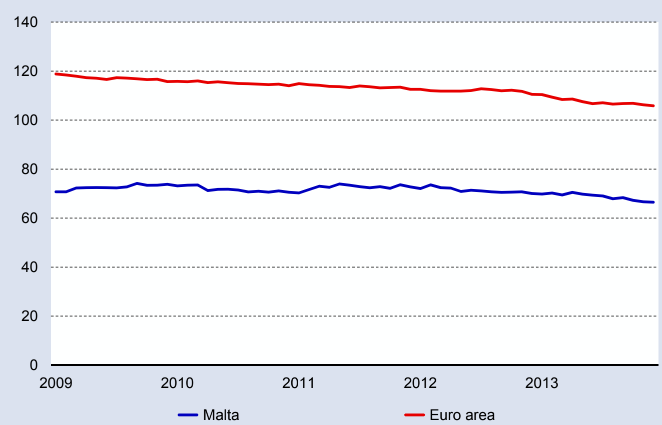
Source: Central Bank of Malta.

Chart 4.4
DISTRIBUTION OF BANK ASSETS - CORE DOMESTIC BANKS
(EUR billions)



Source: Central Bank of Malta.

Chart 4.5
CUSTOMER LOAN-TO-DEPOSIT RATIO - CORE DOMESTIC BANKS
(per cent)



Sources: ECB and Central Bank of Malta.

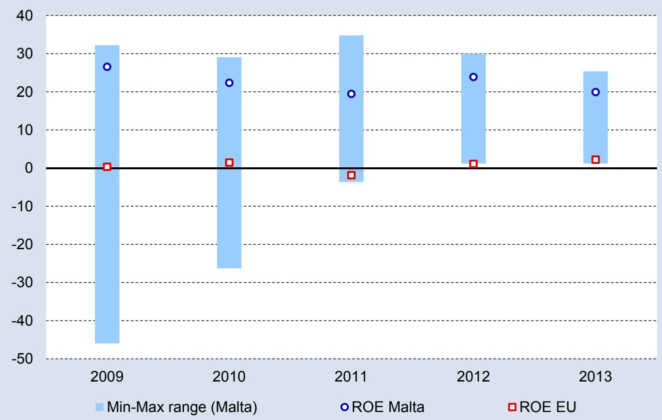
Interbank and Eurosystem funding both dropped in 2013 to just 0.5% of total liabilities. Meanwhile, debt securities issued by core domestic banks remained relatively small and stable in 2013, accounting for 2% of total liabilities (see Section 3.3.2).

4.2 Profitability

Profits of core domestic banks decreased by 8.6% over 2012. Nonetheless, profitability indicators compare favourably with respect to their historical average, and are also noticeably higher than those reported by EU banks. The banks' return on equity (ROE) dropped by 4 percentage points to 19.9%, while the return on assets (ROA) eased by 0.2 percentage point to 1.4% (see Charts 4.6 and 4.7). Although the profitability of small banks in the European Union improved during 2013 with an ROE and ROA of 2.2% and 0.16%, respectively, it is still significantly lower than the level of Malta's core domestic banks. Moreover, the variation in profits between individual banks has shrunk considerably in recent years.

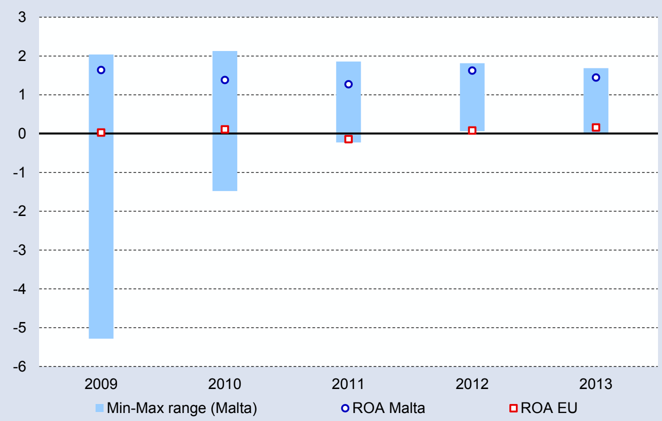
The drop in profits reflected lower net interest income, which declined in 2013 by 6.6%, or €21.6 million (see Table 4.1). Nevertheless, net interest income remains the main contributor to profit, with its share in total gross income amounting to 65.3% in 2013, down from 66.8% a year earlier. This drop mainly reflected developments in the "other" net interest income category, specifically lower securities income coupled with higher interest expenditure. Meanwhile, net interest income from intermediation also contracted, down by €5.5 million owing to a drop in interest income, which was partly offset by a reduction in interest expense. This reflected the decrease in the weighted average interest rates both for loans and deposits, with growth in the volume of deposits exceeding that for loans.

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, 2013 refers to June.
Sources: ECB and 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, 2013 refers to June.
Sources: ECB and Central Bank of Malta.

Non-interest income remained broadly unchanged, accounting for 34.7% of total gross income. The reported drop in trading profits was offset by an increase in other non-interest income. The latter mainly comprises net fees and commissions, which rose by 10.1% to almost €85 million, accounting for 18% of total gross income.

Non-interest expenditure declined marginally, with the increase in other operating expenses offset by a drop in staff expenditure. Furthermore, the flow of loan impairment charges (including write-offs, write-backs,

Table 4.1
MAIN COMPONENTS OF THE PROFIT AND LOSS ACCOUNT
EUR millions

	2009	2010	2011	2012	2013
Total net-interest income	250,988	292,916	314,414	328,679	307,084
Net interest income on intermediation	126,181	206,759	223,487	237,601	232,108
Other net-interest income	124,807	86,157	90,927	91,078	74,975
Non-interest income	151,033	121,619	119,479	163,328	163,232
Trading profits[1]	29,599	1,647	(27,770)	21,573	15,301
Other non-interest income	121,434	119,972	147,248	141,755	147,931
Non-interest expense	(203,024)	(227,438)	(260,032)	(258,481)	(256,760)
Net profit before tax	198,998	187,097	173,861	233,527	213,555

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

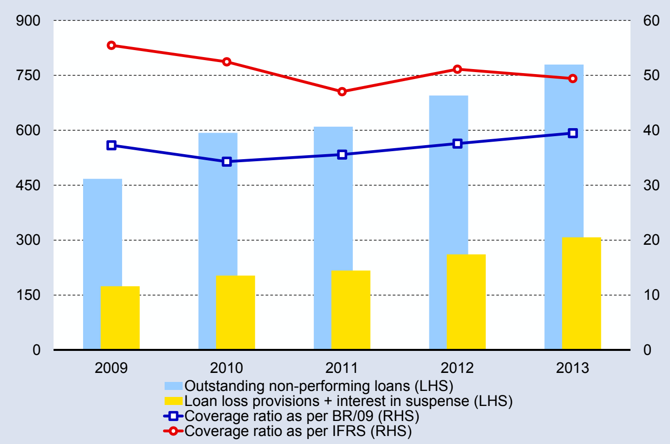
provisions and recoveries) contracted by almost €3 million to €28.4 million, contributing to a small contraction in non-interest expenditure. This, however, reflected lower net specific and collective provision charges, which fell by €5.3 million, partly offset by a rise of €2.5 million in net bad debts written off.

The core banks' traditional business model and stable deposit funding has ensured robust, though reduced, profitability during 2013. A prolonged period of a record low interest rate environment has put downward pressure on interest rate margins and, hence, on banks' profitability. Profitability was also affected by weak credit demand and by an increase in non-performing loans (NPL) of corporates and, to a lesser extent, of households. This also coincided with a period of tighter regulatory requirements, when banks were encouraged to enhance their capital buffers and adopt a more prudent dividend pay-out policy.

4.3 Loan loss provisions

In 2013 the stock of loan loss provisions increased by €23.5 million, equivalent to 15.5%. This reflected higher specific provisions, which rose by 28.7%, with collective provisioning remaining unchanged. The majority of core domestic banks raised their total provisions. Meanwhile, interest in suspense was up by 21%. This increase in provisioning and interest in suspense exceeded the rise of NPLs, leading to a higher coverage ratio, rising by 1.9 percentage points to 39.5% (see Chart 4.8).[1] The coverage ratio based on impaired loans as per International Financial Reporting Standards (IFRS) has, however, dropped marginally from 51.1% to 49.4%.

Chart 4.8
COVERAGE RATIO - CORE DOMESTIC BANKS
(EUR millions; per cent)



Source: Central Bank of Malta.

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

The increase in specific provisions and interest in suspense led to an improvement in the specific provisions-to-NPL ratio, which rose by 3 percentage points to 30.4%. This mainly reflected higher specific provisions and interest in suspense related to loans made to the corporate sector, with the coverage ratio for these loans rising from 28.6% in 2012 to 32.2% in 2013.

Meanwhile, the collateral backing NPLs contracted by 5 percentage points to 70.7%.[2] On aggregate, when taking into account specific provisions, interest in suspense and collateral, core domestic banks' NPLs are fully covered, though with some divergences across banks.

In December 2013, in consultation with the Joint Financial Stability Board and following discussions with the banking industry through the publication of a Consultation Document in September 2013, the MFSA issued a revised Banking Rule BR/09 aimed at countering credit risk (see Box 4).[3] In the first allotment the extent of the total reserve set aside by core domestic banks amounted to €8.5 million. When this reserve is taken into consideration, the coverage ratio (including also total provisions and interest in suspense) would increase by 1.1 percentage points to 40.6%.

BOX 4: BANKING RULE 09 – MEASURES ADDRESSING CREDIT RISKS ARISING FROM THE ASSESSMENT OF THE QUALITY OF ASSET PORTFOLIOS OF CREDIT INSTITUTIONS AUTHORISED UNDER THE BANKING ACT 1994

On 31 December 2013 the MFSA amended Banking Rule BR/09, now entitled "Measures Addressing Credit Risks arising from the Assessment of the Quality of Asset Portfolios of Credit Institutions Authorised under the Banking Act 1994". In May 2012 one of the Country Specific Recommendations (CSR) which the European Commission made with respect to Malta required measures to strengthen provisioning to cover for NPLs and to improve banks' coverage ratios, thus also mitigating potential risks arising from exposure to the real estate market. The European Commission reaffirmed these recommendations in its In-Depth Review for Malta issued on 10 April 2013.[1] The MFSA and the Central Bank of Malta agreed to tackle these issues through appropriate amendments to BR/09. Given the significance of the issues and the potential impact on the whole banking sector, this work was brought within the auspices of the newly established Joint Financial Stability Board (JFSB) between the Bank and the MFSA in January 2013.

The MFSA, in collaboration with the Central Bank of Malta, organised a Working Group with the specific remit to effect the necessary amendments to Banking Rule BR/09. During 2013 presentations were made to the JFSB and a consultation on the proposed amendments to BR/09 was held in September, during which stakeholders provided their views on the Consultation Document issued by the MFSA. After September, however, further discussions were held with the industry. The authorities took on board a number of proposals and made several changes to the original draft. The process of revision to BR/09 was then formally concluded with a final draft of the Rule being endorsed at the end of 2013 by the JFSB. The Rule was formally published in December 2013 and came into force at the end of 2013.

The amended Rule requires the Board of Directors and senior management of a credit institution to implement a robust impairment loss measurement policy and collateral valuation policy as part of its credit risk framework. The new Rule aims to ensure that a credit institution's credit risk management

1 http://ec.europa.eu/europe2020/pdf/nd/idr2013_malta_en.pdf

2 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%.

3 BR/09/2013 "Measures Addressing Credit Risks Arising from the Assessment of the Quality of Asset Portfolios of Credit Institutions Authorised under the Banking Act 1994".

framework includes a provisioning policy commensurate with its operations and risk profile, together with adequate procedures and internal controls, including appropriate reporting systems. Credit risk policy should also comprise a collateral valuation policy, which should as a minimum highlight:

1) the criteria for expertise and independence of the appraiser;
2) the determination of fair value;
3) the determination of costs to sell, if applicable;
4) the assumed time line for recovery;
5) clear instructions to appraisers for the evaluation;
6) the allocation of fees.

The credit risk policy should also include the type of assets that are generally considered acceptable by a credit institution to be pledged by the borrower in its favour as collateral. As part of its ongoing supervision, the MFSA will examine the banks' implementation of these requirements.

IAS 39 requires credit institutions to assess, at the end of each reporting period, whether there is objective evidence that a loan (or group of loans) is impaired.[2,3] The Rule refers to a number of triggers to be used in the determination of applicable impairments. For example, credit institutions should consider the definition of NPLs as an impairment trigger. The Rule aligns the definition of NPLs and forbearance with the European Banking Authority (EBA) draft Technical Standard, which sets a harmonised and comprehensive definition of forbearance and NPLs.[4] The aim of the Rule is for credit institutions to recognise incurred losses as early as possible within the IFRS framework.

The main thrust of the amendments to the Rule lies in the introduction of a new concept through which banks are required to allocate an amount of capital to a reserve (Reserve for General Banking Risks). The objective is for credit institutions to build a capital buffer over and above provisions required by IAS 39, which is aimed at strengthening their loss absorbing capacity to address credit risk.

The regulatory capital allocation is equal to 2.5% of a bank's NPLs, less specific impairments (according to IFRS as adopted in the European Union) and interest in suspense. In the case of non-performing exposures with capital and/or interest past due by 24 months or more, the 2.5% metric shall, as a minimum, increase to 5%. The capital allocation is to be sourced from dividends distributable for the year. In case when a credit institution has total Common Equity Tier 1 capital (CET 1) as per Regulation (EU) No 575/2013 (CRR) that exceeds a threshold determined by the authority, only half (50%) of the appropriation shall be allocated to the "Reserve for General Banking Risks" from the dividend to be distributed for the year.

The Rule allows transitory provisions for the allocation to the "Reserve for General Banking Risks". For the first year the reserve shall be equal to 40% of the regulatory allocation applicable. The remaining amount should be spread equally over the following two years. The Rule also requires the reporting of Banking Rule BR/06 to continue in parallel with those of the EBA Technical Standard.

Through the implementation of such a policy initiative, the authorities strengthened further the regulatory framework and took necessary measures to address the European Commission's country specific recommendations of further strengthening the provisions to cover NPLs and to improve banks' coverage ratios to mitigate potential risks arising from exposure to the real estate market.

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2 IAS 39 "Financial Instruments: Recognition and Measurement".

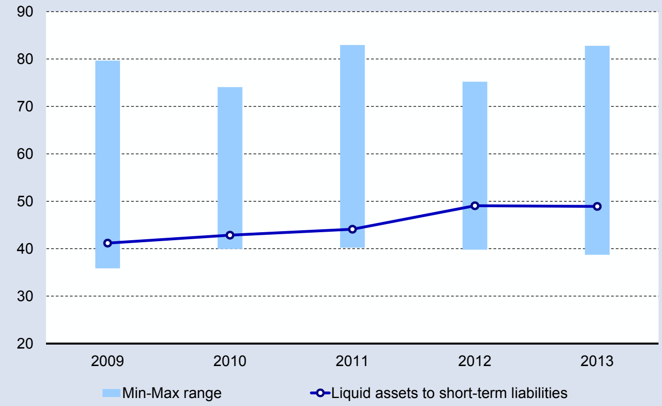
3 IAS 39 states that impairment losses are incurred if there is objective evidence of impairment as a result of one or more events that occurred after the exposure was created and that the loss event has an impact on the estimated future cash flows of the loans and these cash flows can be reliably estimated.

4 EBA Final draft Implementing Technical Standards on Supervisory Reporting on Forbearance and Non-Performing Exposures under Article 99(4) of Regulation (EU) 575/2013 [EBA/ITS/2013/03].

4.4 Liquidity

Throughout 2013 the core domestic banks' liquidity position remained healthy, with the liquidity ratio dropping only marginally by 0.1 percentage point to 48.9%, but remaining significantly above the 30% regulatory threshold (see Chart 4.9).[4] Nevertheless, divergences exist among core domestic banks, with the liquidity ratio ranging between 38.7% and 82.8%. Marketable debt securities remained the main component of liquid assets, at 56.4%. The other key components are balances with the Central Bank of Malta and credit institutions, at 19.9% and 17.7%, respectively.

Chart 4.9
LIQUID ASSETS TO SHORT-TERM LIABILITIES - CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

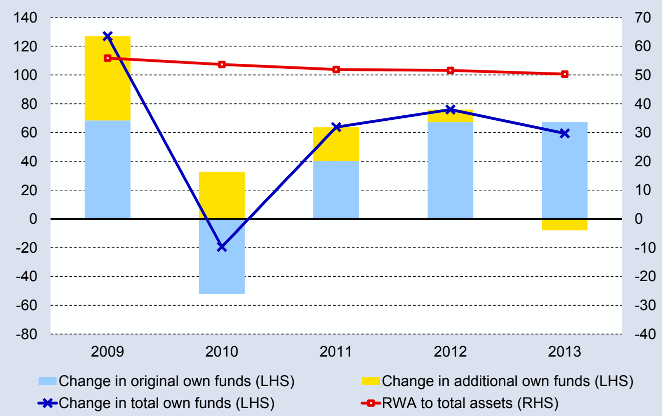
Meanwhile, the bulk of short-term liabilities represent amounts owed to retail customers. A total of 57% of deposits consist of current and savings accounts, underlining the high liquidity preference of depositors (see Section 3.3.1). Historically, such deposits have not shown any volatility and have risen consistently. Nevertheless, it would also be prudent to diversify the sources of funding.

This risk will be addressed by the Liquidity Coverage Ratio (LCR) as part of the Capital Requirements Directive (CRD) IV/CRR framework, which requires banks to maintain enough liquid assets to meet the notional amount of cash outflows occurring over a 30-day period. The LCR will be gradually phased in, with the first milestone of a 60% threshold set for January 2015, subsequently rising in various stages to 100% by January 2018. Early indications show that Maltese banks are restructuring their balance sheets and are expected to meet the new regulatory requirements, particularly reflecting the level of high quality liquid assets they hold.[5]

4.5 Capital and leverage

During 2013 core domestic banks continued to strengthen their capital position, partly in anticipation of the new CRD IV/CRR framework, which includes enhanced requirements for quality and quantity of capital, including capital conservation and countercyclical capital buffers.[6] This is reflected in the Capital Adequacy Ratio (CAR), which grew by 0.8 percentage point to 14.9%, significantly above the 8% minimum statutory requirement. All banks reported higher CARs, though to varying degrees. The increase in the CAR resulted from higher holdings of total own funds, which rose

Chart 4.10
CHANGE IN TOTAL OWN FUNDS AND RISK-WEIGHTED ASSETS - CORE DOMESTIC BANKS
(EUR millions; per cent)



Source: Central Bank of Malta.

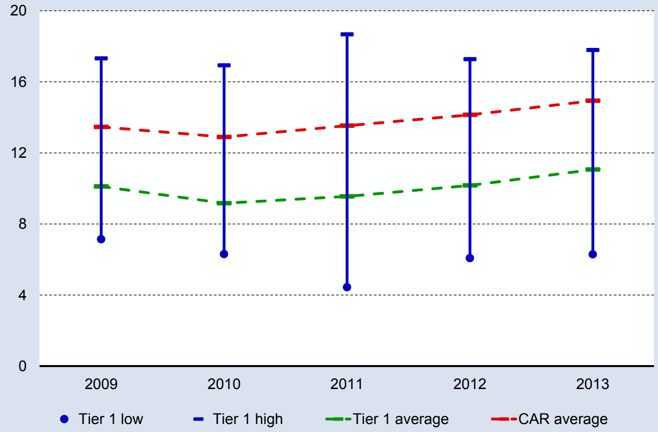
4 The liquidity ratio is defined as liquid assets to short-term liabilities.
5 This is based on information obtained from participant banks in the Bank for International Settlements' Quantitative Impact Study.
6 The new capital requirements will be phased in gradually and will be fully implemented by 2019.

by 5.5% or €59.4 million (see Chart 4.10). Meanwhile risk-weighted assets (RWA) remained practically unchanged.[7] Given the 2.5% expansion in the banks' balance sheet, the risk profile defined as RWA to total assets, dropped from 51.6% in 2012 to 50.3% in 2013.

The increase in total own funds resulted from higher original own funds, up by 8.7% or €67.3 million. This was driven by retained earnings, which were partly converted into new bonus share issues. As a result, the Tier 1 capital ratio increased by 0.9 percentage point to 11.1% (see Chart 4.11). Divergences among core domestic banks however remain, with the Tier 1 capital ratio ranging from a minimum of 6.3% to a high of 17.8%. Meanwhile, additional own funds dropped by 2.6%, or €7.9 million, as a result of lower subordinated loan capital.

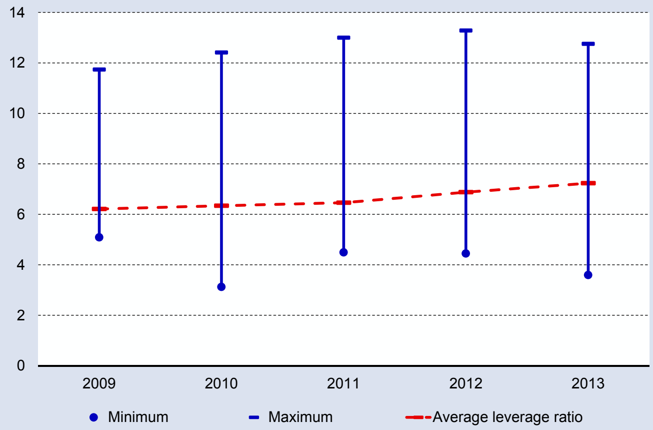
The leverage ratio, defined as capital and reserves as a proportion of total assets, also improved in 2013, rising by 0.4 percentage point to 7.2% (see Chart 4.12). Nevertheless, the distribution shifted marginally downwards, with the lowest ratio dropping to 3.6%.

Chart 4.11
CAPITAL RATIOS - CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

Chart 4.12
LEVERAGE RATIO - CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

4.6 Stress tests

As part of the financial stability toolkit of the Central Bank of Malta, stress-testing exercises are carried out to analyse the resilience of the domestic financial system to extreme, yet plausible, shocks. The stress tests broadly capture elements of credit, sovereign, liquidity and market risks. More specifically, the tests presented are based on the following four scenarios:

1) a credit quality deterioration in the securities portfolio;
2) a drop in property prices;
3) an increase in NPLs owing to adverse macroeconomic conditions;
4) persistent deposit withdrawals.

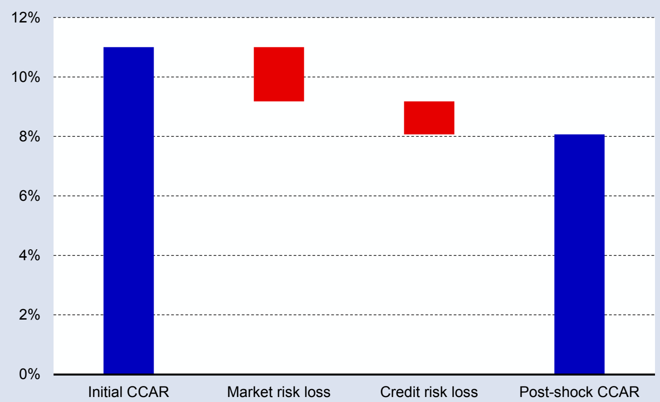
The risk outlook remains the same as in the previous *Report*, namely that the probability of the first three scenarios occurring continues to be low, whereas the likelihood of a deposit run materialising is deemed remote. Results should be considered as indicative, in view of the fact that these tests are univariate in nature and do not incorporate possible second-round effects.

[7] The core domestic banks follow the "standardised approach" for capital adequacy, meaning that the calculation of risk weighted assets is based on pre-set weighting for various asset classes.

Scenario 1: Credit quality deterioration in the securities portfolio

This stress test assesses the impact on balance sheets of core banks stemming from deterioration in the credit quality of the securities portfolio, which is assumed to lead to a revaluation of market-sensitive securities. The shock to credit risk is carried out by simulating a three-notch downgrade reflected in higher probabilities of default (PD) in all securities in the portfolio, whilst market valuation haircuts are applied to non-held-to-maturity (HTM) securities to reflect increased market risk. The haircuts applied to the sovereign portfolio are determined on the basis of the term to maturity of the security and the country of origin, mirroring the 2014 EBA EU-wide Stress-Test methodology. A haircut, reflecting the highest daily drop in the Euro Stoxx 50 index since 2007, is applied on the remaining non-HTM securities.

Chart 4.13
STRESS TEST RESULTS - IMPACT OF DETERIORATION IN SECURITIES PORTFOLIO ON TIER 1 CAPITAL
(per cent)



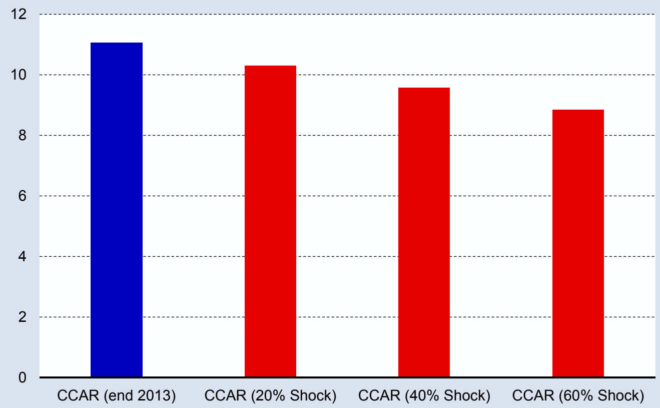
Source: Central Bank of Malta calculations.

As at the end of 2013, around 42% of total securities owned by banks attracted a credit rating higher than A-; almost 99% of securities were classified as investment grade. Portfolio investment in MGS amounts to around 50% of the total securities' portfolio of core banks, which in turn represents 24% of their aggregated balance sheets. Following the application of a three-notch downgrade and market valuation haircuts, the aggregate banks' core capital ratio would remain significantly above the 4% regulatory threshold whilst also satisfying higher regulatory thresholds as per CRD IV /CRR (ceteris paribus) (see Chart 4.13).

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

This scenario assumes that following an adverse macroeconomic shock, NPLs increase in the range from 20% to 60% in selected key economic sectors consisting of households, 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 rise in NPLs, leading to a drop in profits and consequently translating into lower capital.

Chart 4.14
STRESS TEST RESULTS - IMPACT OF AN INCREASE IN NPLs IN KEY ECONOMIC SECTORS ON TIER 1 CAPITAL
(per cent)



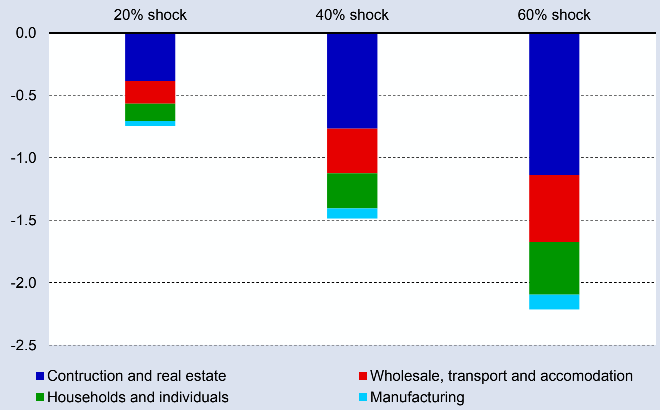
Source: Central Bank of Malta calculations.

Furthermore, the banks' capital ratio is also negatively influenced by higher risk weights associated with NPLs.

The results reveal that even under the most extreme scenario (i.e. 60% increase in NPLs in key economic sectors), the aggregate banks' Tier 1 capital ratio remains comfortably above the regulatory threshold of 4%, standing at 8.9% (see Chart 4.14).

At a sectoral level, the main contributors to the fall in the Tier 1 capital ratio are the construction and real estate sectors, reflecting the larger share of NPLs reported in these sectors (see Chart 4.15).

Chart 4.15
STRESS TEST RESULTS - IMPACT OF AN INCREASE IN NPLs BY SECTOR ON TIER 1 CAPITAL
(percentage points)



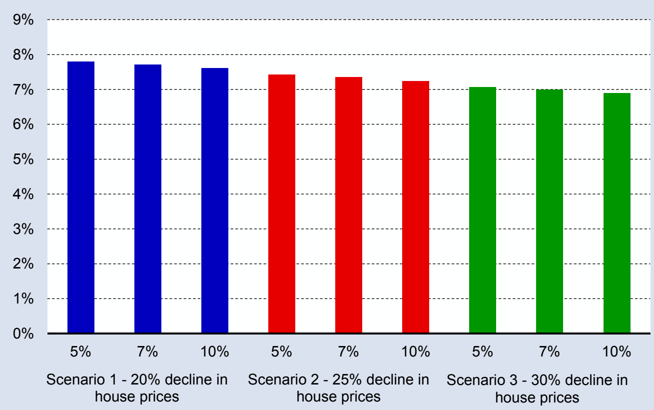
Source: Central Bank of Malta calculations.

Scenario 3: A drop in property prices

This extreme scenario assumes a drop in property prices by varying degrees, which in turn is translated into lower loan collateral values.[8] The assumed haircuts on collateral are applied on the already discounted extendible collateral values reported by banks.[9] The test assumes that as collateral values decline, loan loss provisions will need to be raised accordingly. Furthermore, this scenario is assumed to coincide with a significant increase in NPLs, owing to a negative wealth effect, leading to a further increase in provisions.

Under such a scenario 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 4.16).

Chart 4.16
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.

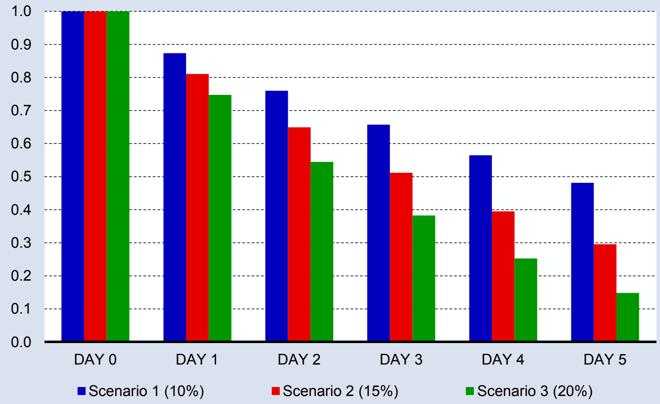
8 Around 71% of the banks' collateral consists of immovable property.

9 Extendible value of collateral differs from the market value of collateral. The former refers to the value of collateral to which the credit institution has the right of recourse – this is generally lower than the market value. Consequently, the test may be considered as rather extreme.

Scenario 4: Persistent deposit withdrawals

This scenario stresses the liquidity position of banks by assuming persistent deposit withdrawals ranging from 10% to 20% for five consecutive days. Banks are assumed to utilise the full range of liquid assets on their balance sheets, which qualify as liquid under the relevant MFSA Banking Rules, without tapping other funding sources, such as ECB funding.[10] As shown in Chart 4.17, on aggregate, banks would remain liquid (i.e. in positive territory) during the five days of the test. At individual institution level, one bank would need to utilise, to a small extent, other funding sources to meet a five-day persistent deposit withdrawal.

Chart 4.17
STRESS TEST RESULTS - IMPACT OF PERSISTENT DEPOSIT WITHDRAWALS ON LIQUID ASSETS
(1 = liquidity index prior to shock)



Source: Central Bank of Malta calculations.

BOX 5: THE CREDIT RISK THRESHOLD MODEL

The Central Bank of Malta has complemented its suite of analytical models with a Credit Risk Threshold Model (CRTM). The model aims to quantify credit risk arising from new borrower defaults in the performing loan portfolio of selected banks against banks' loss absorption capacity consisting of collateral, collective provisions and capital.[1] Credit risk is measured off a simulated loss distribution, taking into consideration individual bank defaults simulated by the model. Bank specific sectoral default rates and NPL ratios are used as input for the model, together with banks' loan portfolio specificities. Credit risk indicators, such as Expected Loss, Value-at-Risk and Expected Shortfall are derived from the loss distribution. The model assumes that banks can tap into their allocation of collective loan loss provisions and collateral liquidation in order to absorb the estimated losses.

Simulating new borrower defaults

The CRTM employs a Monte Carlo simulation engine to simulate the asset value of each borrower at granular level as a combination of idiosyncratic and sectoral (exogenous) shocks, i.e. the asset value of the borrower is assumed to be determined by both a sectoral shock (which is based on the pairwise correlation among the sectoral NPL ratios) and an idiosyncratic shock based on a random error term. The following is a mathematical representation of the simulation function:

$$\mathrm{X}_{\mathrm{i,s,t}} = \left[\mathrm{r_s Y_t} + \varepsilon_{\mathrm{i,s,t}}\sqrt{1 - r_s^{\,2}}\right]$$

where:

$\mathrm{X}_{\mathrm{i,s,t}}$	is the simulated asset value of borrower i in sector s
$\mathrm{r_s}$	represents a sectoral factor weight and takes values between 0 and 1
$\mathrm{Y_t}$	is the matrix of correlated sectoral NPL ratios at time *t* representing the exogenous shock
$\varepsilon_{\mathrm{i,s,t}}$	is a matrix of standard normal random numbers representing the borrower specific (idiosyncratic) risk factor

[1] The selected banks include core domestic banks and four non-core banks that hold a sufficiently large loan portfolio for which significant results can be obtained from the CRTM.

[10] Liquid assets as per MFSA Banking Rule include (i) cash balances with the central bank, (ii) excesses on reserve deposit requirement, (iii) Treasury bills, (iv) balances with credit institutions and (v) marketable debt securities.

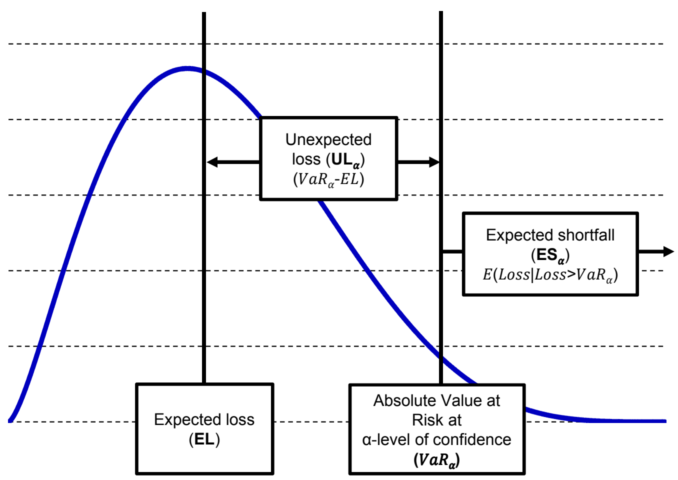
The value of r_s determines the weight to be placed on the idiosyncratic and sectoral shocks. When r_s= 0, the asset value of the borrower is determined entirely by the error term $\varepsilon_{i,s,t}$ i.e. the idiosyncratic shock, whereas if r_s=1, the asset value of the borrower is determined solely by the sectoral shock. Following sensitivity analyses, the value of r_s is set at 0.5. Hence, the borrower value is determined by both the idiosyncratic and sectoral shocks. The exogenous shock targets all borrowers within an economic group and its impact can be amplified by similar shocks applied to sectors that are directly correlated.

The model is repeated for 5,000 scenarios. The simulated asset values are then compared against a sectoral default threshold p_s, derived from observed default rates, with new defaulting borrowers identified as those with a simulated asset value that falls below the respective threshold. All loans belonging to defaulting borrowers in each scenario are aggregated to represent the overall loss. The losses generated from each scenario are then combined to form the loss distribution.

Loss Distribution

The following credit risk parameters are inferred from the loss distribution (see Chart 1); (i) the Expected Loss (EL), which is equal to the average of the distribution, (ii) the Absolute Value-at-Risk (VaRα), which at the α-level of confidence covers both the EL and the Unexpected Loss and represents the α-percentile of the distribution and (iii) the Expected Shortfall (ES), which is defined as the expected value (probabilistic average) of the losses exceeding the VaRα (located in the right tail of the distribution). The expected shortfall thus provides a measure of capital that would be required as a buffer to absorb losses arising from extremely low probability, but high impact, events.

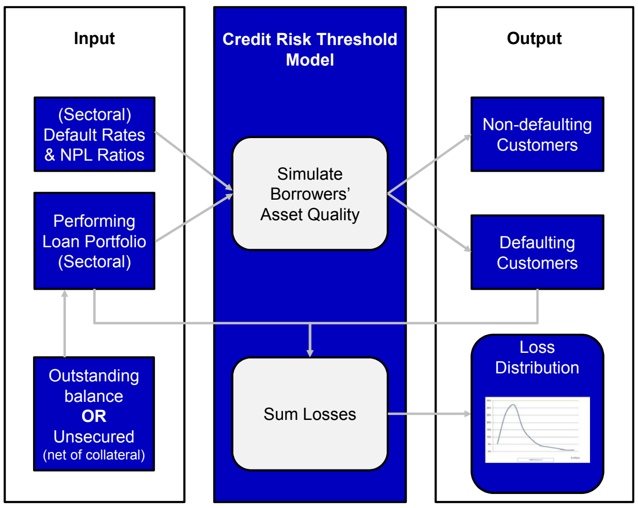
Chart 1
LOSS DISTRIBUTION



Model Output

Chart 2 provides a schematic representation of the process involved in the simulation of credit risk losses by the CRTM. The model provides two sets of outputs for

Chart 2
CREDIT RISK THRESHOLD MODEL PROCESS



each bank, one assuming that the reported value of collateral attached to defaulting loans can be fully recovered, and in the other instance, the loan losses are borne entirely by the bank collective provisions (as a primary loss absorption) and capital, thus assuming, at the extreme, that no value whatsoever is recovered from the available collateral. The two sets of outputs, at the two confidence levels, produce linear ranges of values for each credit risk indicator. Both outputs allow easy inference of the minimum recovery of collateral that is necessary for the banks to still satisfy the regulatory capital requirements. The effectiveness of collective provisions in absorbing the EL is also considered, whilst any uncovered losses (not absorbed through collateral and provisions) are charged directly to capital.

The model is run bi-annually, with the output presented to the JFSB. The model output is also used as input to the *Report* as well as for other analyses conducted within the Financial Stability Department.

5. THE OTHER COMPONENTS OF THE FINANCIAL SYSTEM

This Chapter presents an overview of the remaining components of the domestic financial sector. Section 5.1 analyses possible financial stability implications emanating from non-core domestic and international banks, whilst Section 5.2 examines insurance companies and the investment funds sector. The operations of non-core domestic and international banks remain satisfactory. However, the year was characterised by a voluntary retrenchment in business operations by some institutions, which affected profitability levels. Interlinkages with the domestic economy remained very limited.

The insurance and investment funds sectors continued to pose limited risks to the domestic financial system, given their relatively small size and their favourable financial conditions. Potential risks stemming from their links with core domestic banks, which can propagate shocks through the financial system, are deemed to be remote.

5.1 Non-core and international banks

5.1.1 Non-core domestic banks

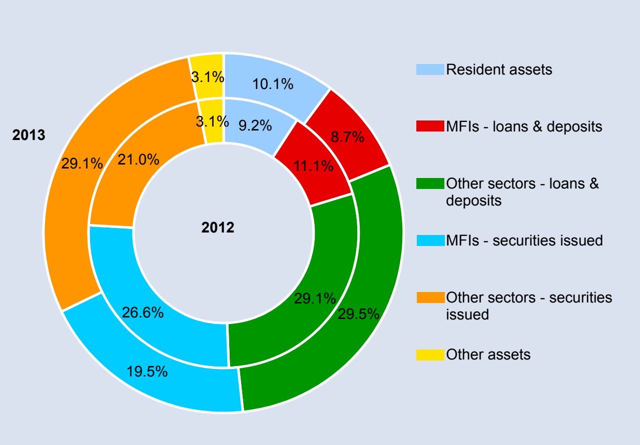
The number of banks classified in the non-core domestic group increased to nine in 2013, as a result of a reclassification of a bank which was previously categorised as international.[1] The business of non-core domestic banks continued to be conducted mainly with non-residents as reflected in their balance sheets. Indeed, resident assets and liabilities stood at 10.1% and 18%, respectively, of their total balance sheet as at end-2013. During the year, the total assets of this group of banks went up by 1.7%, reaching around 74% of gross domestic product (GDP) in size.

Asset structure

As at end-2013, the total value of non-core domestic banks' assets stood at €5.3 billion. As in previous years, the growth in assets consisted of higher foreign securities. Indeed, while these banks have significantly reduced their holdings of securities issued by monetary financial institutions (MFI), down by a quarter to 19.5% of total assets, they reported higher holdings of securities mainly issued by foreign non-financial companies. The latter accounted for 29.1% of total assets as at end-2013. Furthermore, interbank lending (including deposits) dropped by the 2.4 percentage points to 8.7% of total assets (see Chart 5.1).

During the year total lending increased by 1.3%, partly reversing the drop recorded in 2012, with around 90% of the increase in such lending granted to non-residents. This mainly reflected a higher volume of corporate loans, which increased by 3% reaching €1.5 billion, despite a decline in lending to corporates in the real estate and construction sector. At the same time, household lending contracted by 3.1% to €20.9 million and lending to non-bank financial institutions declined by 12.5% to €260.5 million. As a result, customer loans dropped marginally. The fall in customer loans was driven by the developments in lending to

Chart 5.1
ASSET STRUCTURE - NON-CORE DOMESTIC BANKS

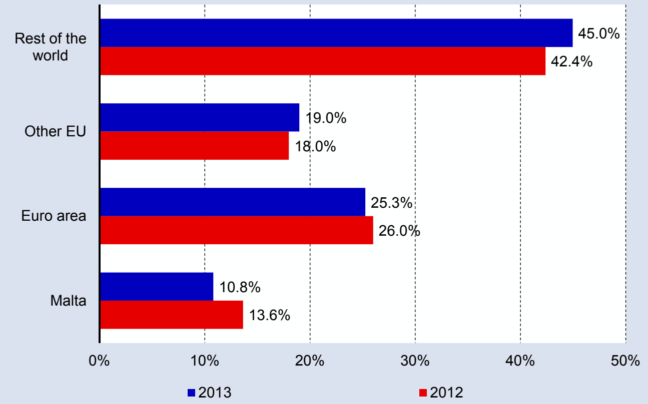


Source: Central Bank of Malta.

[1] For comparison purposes data for 2012 includes the bank which was previously classified as international.

Maltese residents, which declined to 10.8% of total customer loans. Similarly, loans to euro area residents fell to 25.3% of total customer loans. Meanwhile, customer loans to non-EU countries (rest of the world), which account for the largest share, increased to 45% of total customer loans. Loans granted to customers from non-euro area Member States also rose, accounting for 19% of total customer loans (see Chart 5.2).

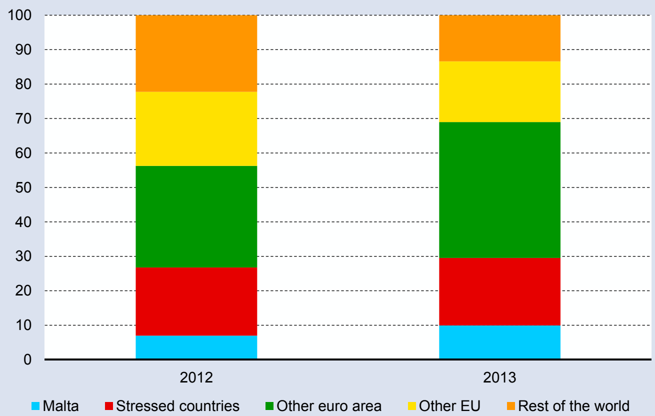
Chart 5.2
CUSTOMER LOANS BY RESIDENCY - NON-CORE DOMESTIC BANKS
(per cent)



Note: Data for euro area excludes Malta.
Source: Central Bank of Malta.

Although non-core domestic banks' non-performing loan (NPL) ratio remained relatively low at 4.7%, there was a small rise of 0.7 percentage point, mainly due to a loan to a resident sector that was related to a real estate project. NPLs related to the non-resident transport and storage sector also increased, but to a lesser extent. In contrast, NPLs of the resident construction sector declined compared with a year ago.

Chart 5.3
INVESTMENT SECURITIES BY RESIDENCY - NON-CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

During the year the securities portfolio expanded by 7.6%, mainly reflecting higher holdings of securities issued by non-stressed euro area countries. These were up by 44%, to around 39% of the banks' total securities portfolio (see Chart 5.3). Holdings of domestic securities, mainly comprising government paper, also increased by 53.1%, to around 10% of the banks' total securities portfolio. Meanwhile, holdings of securities issued in stressed countries rose by 6.7%, and continued to represent 20% of the investment portfolio. On the other hand, holdings of securities issued in EU countries outside the euro area dropped by 11.8% to 17.6% of the total portfolio, while holdings of securities issued in non-EU countries (rest of the world) declined by 35.2% to around 13.4% of the total portfolio.

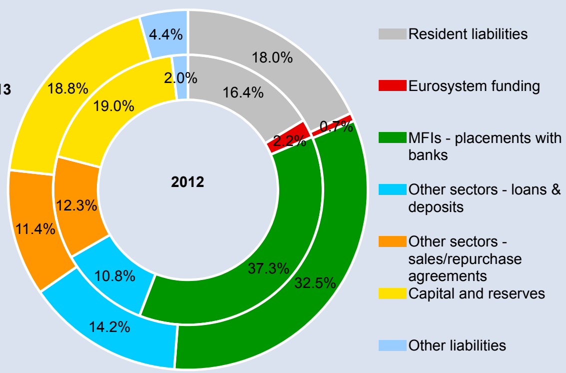
Funding structure

Non-core domestic banks fund their operations primarily from wholesale sources, which accounted for around 44% of their total liabilities in 2013 (see Chart 5.4).[2] Most of this funding originates from non-related institutions. Indeed, owing to the retrenchment of funding by one parent bank towards its subsidiary in Malta, the aggregate reliance of non-core domestic banks on parent funding declined significantly from 11.6% to 6.6% of total liabilities. Eurosystem funding, which is considerably smaller, also fell, down to 0.7% of total liabilities from 2.2% a year earlier. Resident interbank liabilities remained negligible at 0.3% of total liabilities.

[2] Wholesale funding consists of placements of loans and deposits from banks, and sale and repurchase agreements.

The deposit base of non-core domestic banks mainly involves non–residents, who accounted for 60.6% of all deposits in this category of banks as at end-2013. As was evident during the past years, the upward trend in customer deposits in this group of banks was sustained, rising by 29% to 29.5% of total liabilities in 2013. The amount of deposits covered by the Depositor Compensation Scheme (DCS) increased by 1.6 percentage points to 7.8% of the total covered deposits of the whole banking sector.

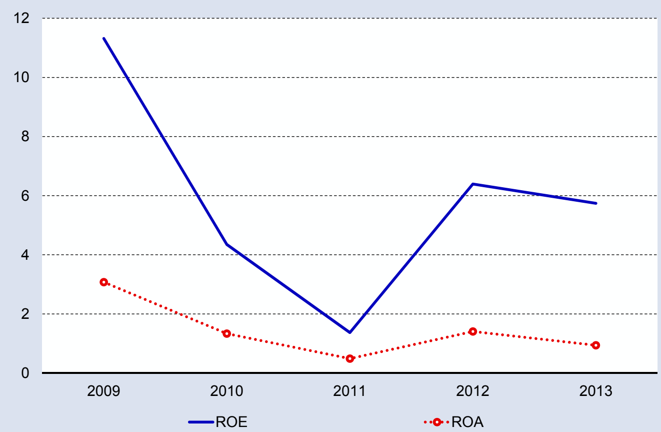
Chart 5.4
LIABILITIES STRUCTURE - NON-CORE DOMESTIC BANKS



Source: Central Bank of Malta.

Following redemptions during 2013, the value of outstanding bonds issued by non-core domestic banks listed on the Malta Stock Exchange (MSE) dropped from around €100 million to about €45 million, equivalent to 5.2% of the value of all corporate bonds (including bank securities) listed on the Exchange at the end of 2013. Around 94% of such securities were held by residents of Malta.

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



Source: Central Bank of Malta.

Profitability

In 2013 non-core domestic banks reported a drop of 30.9% in their profits over the previous year. This was, however, due to an extraordinary revaluation gain in 2012.[3] Excluding this factor, the profits of non-core domestic banks would have risen significantly in 2013. This increase was supported by higher net interest income, which was, however, partly offset by the voluntary scaling down of operations of some subsidiaries and higher impairment charges. As at end-2013, the return on equity (ROE) stood at 5.7% down from 6.4% in 2012, whereas the return on assets (ROA) was at 0.9%, down from 1.4% (see Chart 5.5).

Capital adequacy and liquidity

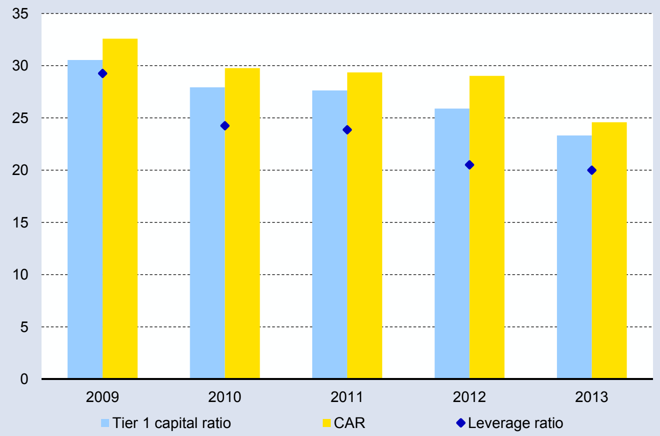
The non-core domestic banks' capital position remained strong. The capital adequacy ratio (CAR) remained comfortably above the 8% minimum threshold, though it declined from 29.0% in 2012 to 24.6% in 2013 (see Chart 5.6).[4] Similarly, the Total Tier 1 capital ratio also dropped from 25.6% to 23.0%, but remained significantly above the 4% minimum regulatory threshold. The decline in the capital ratio resulted mainly from an increase in risk weighted assets, reflecting changes in the securities portfolio and higher corporate

[3] Excluding the one-time extraordinary gain recorded in 2012, the ROE and ROA for 2012 would have been 0.5% and 0.4%, respectively.
[4] Tier 1 capital is mainly composed of shareholders' equity. Total capital is composed of Tier 1 capital and Tier 2 capital.

lending. Similarly, the leverage ratio remained strong, albeit narrowing slightly over the previous year from 20.5% to 20.0%.

These banks continued to improve their liquidity position, with the liquidity ratio (liquid assets as a percentage of short-term liabilities) reaching 95.9%, up from 82.6% in 2012, and significantly above the 30% regulatory threshold.

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



Source: Central Bank of Malta.

5.1.2 International banks

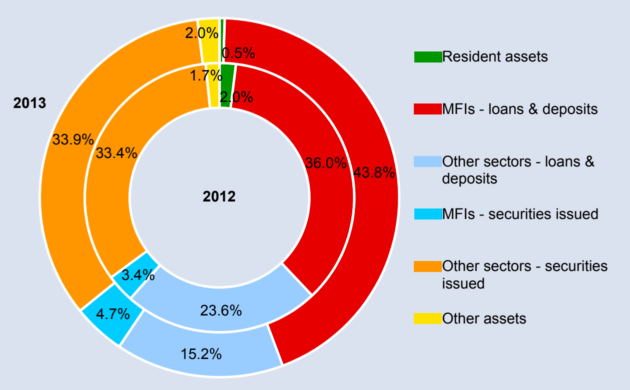
In 2013 two new banks started operating in the international banking sector while another surrendered its licence following the parent company's strategic decision to cease operations in Malta.[5] Since a bank was reclassified from the international bank's category to a non-core domestic bank, the total number of international banks stood at 13.[6] The total assets of this group of banks amounted to €29.7 billion, equivalent to around 413% of GDP, down from 484.8% in 2012. The majority of these assets pertained to two branches of international banks.

Asset structure

During 2013 total assets of international banks contracted by 10.9%. This drop mainly reflected the voluntary reduction of operations of a very small number of banks. In particular, owing to consolidation of activities at group level, one bank reduced its excess capital, while another downsized its activity in preparation for termination of operations. After accounting for these developments in these banks, the aggregate size of the other internationally-oriented sector increased marginally during the year. These developments were sufficient to significantly influence the size of the total banking sector in Malta (i.e. core, non-core and international), which contracted from 774.8% of GDP in 2012 to 697.3% in 2013.

The contraction in total assets of international banks involved predominantly customer lending, which dropped from a proportion of 23.6% in 2012 to 15.2% of total assets in the subsequent year (see Chart 5.7). The fall in non-resident lending was brought about by branches of international banks, and by another bank which reported voluntary reductions in its operations. This contraction was partly offset by higher placements with banks, in the form of both loans and deposits; such placements rose from 36.0% to 43.8% of total assets. Meanwhile, holdings

Chart 5.7
ASSET STRUCTURE - INTERNATIONAL BANKS



Source: Central Bank of Malta.

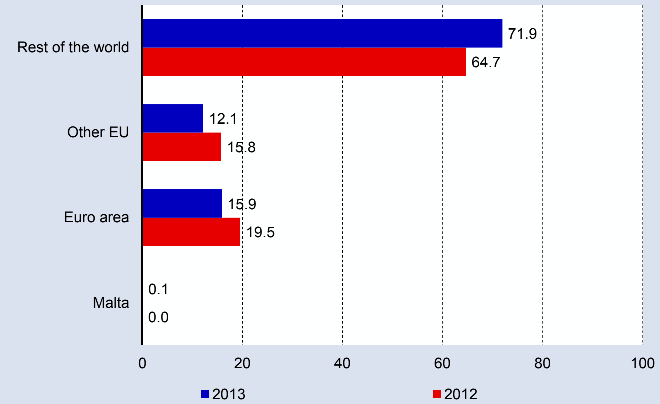
[5] The two new banks are Agribank plc and Ferratum Bank Ltd, which were licensed on 30 October 2012 and 12 September 2012, respectively and started operations in 2013. Fortis Bank Malta Ltd ceased operations on 18 February 2013.
[6] On 3 January 2014, the MFSA granted a banking licence to Pilatus Bank Limited. For financial stability purposes, this bank is considered as an International bank.

of corporate securities dropped by 9.8%, though these continued to represent almost 34% of total assets. The low inter-linkages with the domestic economy were once more reaffirmed by the small share of resident assets, which accounted for 0.5% of total assets in 2013, dropping from 2% in 2012.

Customer lending was largely influenced by the operations of branches of international banks. This is reflected in the proportion of lending channelled outside the European Union, equivalent to 71.9% of the international banking sector's total loans (see Chart 5.8). Indeed, when excluding these branches, the proportion for the remaining banks falls to around 27.1%. Lending to residents remained negligible. Overall, the NPL ratio remained low at 1.2%, though up from 0.5% in 2012, mainly owing to a reduction in total loans.

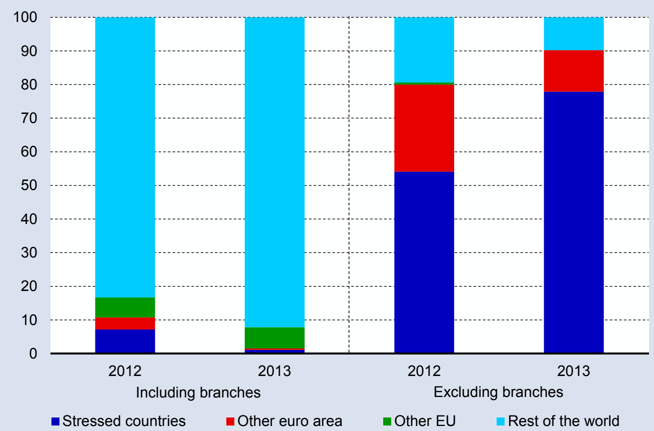
As in the case of the loan portfolio, the investment portfolio is also largely influenced by the branches of international banks, each having a securities portfolio that consists almost entirely of securities issued in countries outside the European Union (see Chart 5.9). Indeed, in 2013 these two branches further increased their holdings of such securities. In contrast, the other banks reduced their holdings of non-EU securities.

Chart 5.8
CUSTOMER LOANS BY RESIDENCY - INTERNATIONAL BANKS
(per cent)



Note: Data for euro area excludes Malta.
Source: Central Bank of Malta.

Chart 5.9
INVESTMENT SECURITIES BY RESIDENCY - INTERNATIONAL BANKS
(per cent)



Source: Central Bank of Malta.

Nevertheless, holdings of securities issued in stressed euro area countries also dropped substantially; these accounted for almost 78% of their total securities portfolio in 2013. The latter securities are totally related to MFIs that mainly originate from Italy (44% of total securities), Spain (31%) and to a lesser extent, Portugal (3%). International banks do not hold Maltese government paper.

Funding structure

As in the case of non-core domestic banks, international banks mainly rely on wholesale funding, which as at end-2013 accounted for almost 60% of total liabilities (see Chart 5.10). Wholesale funding specifically comprises placements by other banks, with a significant portion involving unrelated credit institutions. Furthermore, banks in the international sector rarely fund their operations through the domestic interbank market. They also make minimal use of Eurosystem funding. During 2013 this remained unchanged at 0.3% of total liabilities. Meanwhile, funding from customer deposits increased further from 17.9% to 21.1%

of total liabilities. Total deposits covered by the domestic DCS also remained minimal with a marginal increase from 0.5% to 0.9% of total covered deposits. Capital and reserves dropped from 25.1% to 17% of total liabilities, reflecting the decision of two banks to scale down their operations.

Profitability

In line with the contraction in operations by a number of international banks in 2013, the profits of this category shrank by 36.9%. Excluding the effect on the contraction of operations, the remaining banks booked lower profits during the year mainly as a result of foreign exchange losses and lower interest income. Consequently, in 2013 the ROE and ROA stood at 2.7% and 0.8%, respectively, down from 3.6% and 1.3% a year earlier (see Chart 5.11).

Capital adequacy and liquidity levels

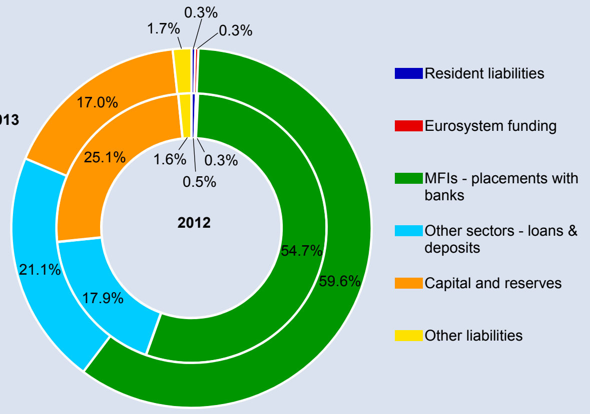
The capital adequacy position remained robust, with the Tier 1 capital ratio increasing further from 115.2% to 119.2% in 2013 (see Chart 5.12). In this segment of the banking industry, the total capital adequacy ratio is almost entirely composed of Tier 1 capital. Furthermore, the leverage ratio remained strong at 75.2%, up from 68.7%, whereas liquidity remained ample at 204.2%, well above the domestic minimum regulatory requirement of 30%.

5.2 Insurance and investment fund sectors

5.2.1 Domestic insurance companies

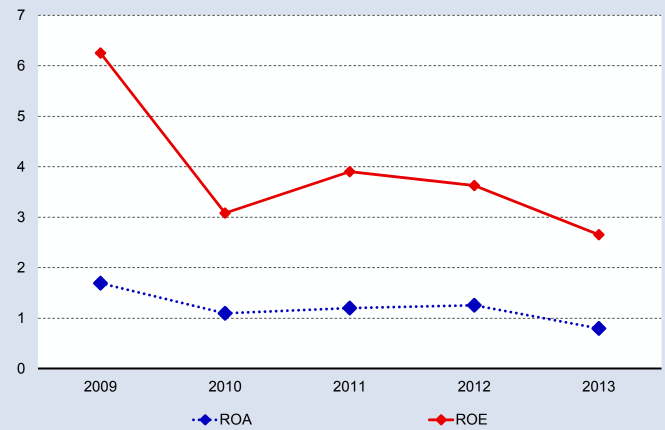
At the end of 2013 there were 35 insurance principals licensed by the MFSA, of which three life and six non-life insurance companies have

Chart 5.10
LIABILITIES STRUCTURE - INTERNATIONAL BANKS



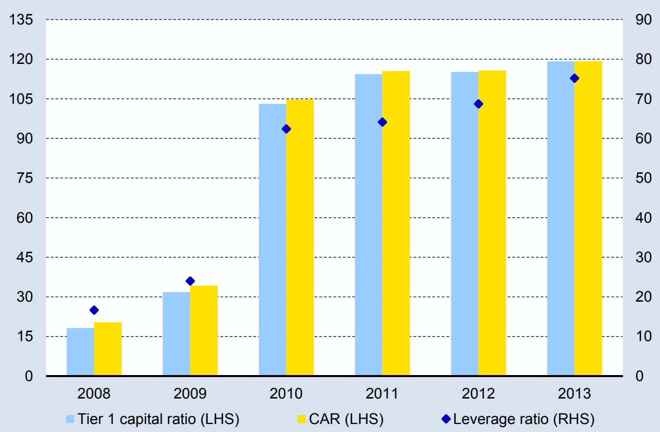
Source: Central Bank of Malta.

Chart 5.11
PROFITABILITY - INTERNATIONAL BANKS
(per cent)



Source: Central Bank of Malta.

Chart 5.12
CAPITAL AND LEVERAGE RATIOS - INTERNATIONAL BANKS
(per cent)



Source: Central Bank of Malta.

strong links with residents. Given their potential systemic relevance, these nine companies (henceforth referred to as domestic insurance companies) are the focus of this report. These companies' total assets amounted to €2.4 billion (life: €2.1 billion, non-life: €286.4 million) and are equivalent to 15.9% of core domestic banks' total assets as at the end of 2013. Their gross premia amounted to 4.1% of GDP. These insurers are important in mobilising savings - holding 11% of household financial wealth - and in acting as institutional investors, investing 70.8% of their balance sheet value.

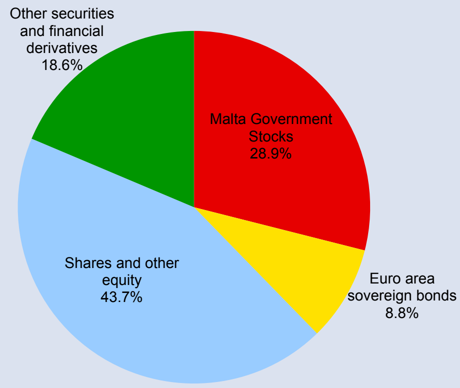
Interconnectedness with other market participants arises as a by-product of the key economic functions of insurers, namely risk transfer and pooling of risks. Indeed, core domestic banks hold a significant shareholding in three of the nine domestic insurance companies (two life insurance companies and one non-life insurance company). Also, such links are evidenced by the fact that 11.4% of insurers' total assets consist of deposits held with the banking sector in Malta.

The sector remained concentrated, with one insurance company accounting for 57.1% of the sector's total assets and 36.4% of the gross premium written. Indeed, the gross premium written for risks situated in Malta by insurance companies established abroad remained minimal.

Insurance companies' assets mainly consisted of investment holdings, which amounted to €1.7 billion as at the end of 2013. The total investment portfolio of insurance companies was mainly composed of domestic and other euro area sovereign holdings (37.7%) and equity holdings (43.7%) (see Chart 5.13).[7] Shares and other equity held by the insurance sector are mainly issued outside Malta (71.3% of all shares and equities). These mainly consist of shares and equity issued by financial intermediaries in euro area Member States (excluding Malta). With regard to shares and other equity issued in Malta (28.7%), these holdings were spread across those issued by banks, insurance companies and non-financial corporations. The sector's portfolio included limited holdings issued in stressed or emerging countries.

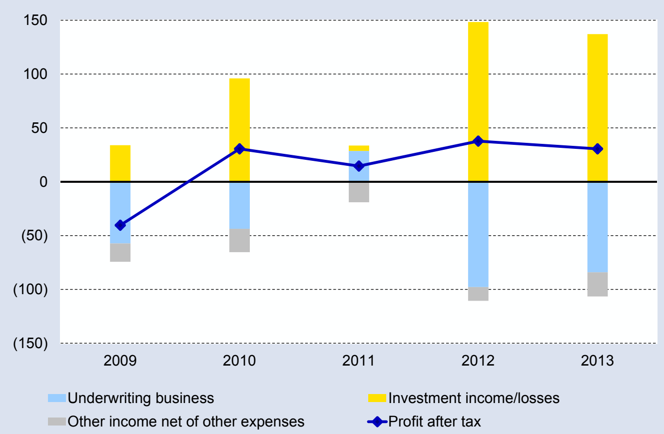
During 2013 profits after tax amounted to €30.6 million and were 18.9% (€7.1 million) lower than those reported a year earlier (see Chart 5.14). The drop was registered by the life sector, in which profits slipped by 33.3%, while profits for the non-life sector increased by 19.9%. Profits were negatively affected by a drop of

Chart 5.13
INVESTMENT ASSETS OF THE INSURANCE SECTOR
(per cent)



Source: Central Bank of Malta.

Chart 5.14
PROFIT COMPONENTS OF THE INSURANCE SECTOR
(EUR millions)



Source: Central Bank of Malta.

[7] Equity holdings include mutual fund shares.

7.5% (€11.2 million) in investment income earned by the life sector due to adverse market conditions. The non-life sector registered an increase in investment income.

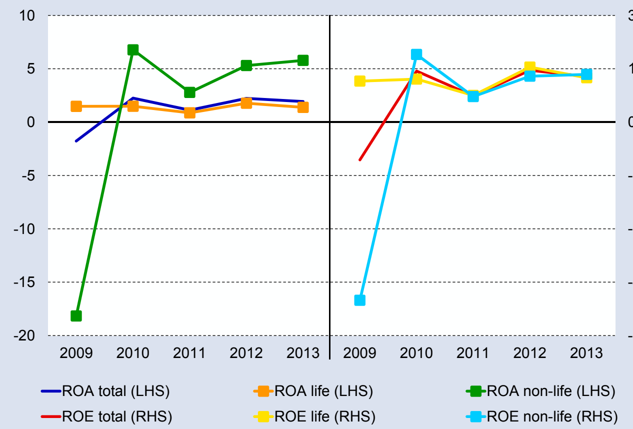
Underwriting business proceeds remained in negative territory as expenses related to underwriting (namely reserves set aside for future claims) exceeded income, although there was some improvement on the year before.[8] Indeed, net premia written increased by 10.2% (€23.6 million) while net claims paid dropped by 2.1% (€3.5 million).[9]

The life sector led the increase in net premia thanks to a rise in the single premium business.[10] The drop in net claims occurred wholly in the life sector, as in 2012 the latter had a much larger number of investment-type policies which matured. Although improvements in the underwriting business were mainly reported by the life sector, the non-life insurers also maintained favourable underwriting performance, as shown by the combined ratio of this sector.[11] The ratio stood below 100%, at 97.1%, dropping from 97.9% during the year, mainly owing to an increase in net premia. Drops in both net claims and other expenses also contributed to the improvement in the ratio. The median combined ratio of a sample of large insurance groups in the European Union stood at 94.8% in the second half of 2013.[12]

The drop in profits reported by the aggregate life insurance sector was reflected in their ROA and ROE, as these declined from 1.8% to 1.4% and from 15.5% to 12.5%, respectively, during the year (see Chart 5.15). In the case of non-life companies, improvements in profit after tax led their ROA to increase from 5.3% to 5.8% and the ROE to improve from 12.9% to 13.4%. The ROE ratio for the whole insurance sector stood at 12.8% as at the end of 2013 and compares favourably with the median ROE of 10.3% of large EU insurance groups during the same period.[13]

The risk retention ratio was estimated at 71.8% for the non-life segment and at 95.5% for the life business.[14] The median risk retention ratio of the aggregate domestic insurance sector stood at 77.6%, while that of a sample of large EU insurance groups stood at 95.5% at the end of 2013, indicating that domestic insurance companies retain a relatively lower risk in their balance sheet.[15]

Chart 5.15
PROFITABILITY OF THE INSURANCE SECTOR
(per cent)



Source: Central Bank of Malta.

The insurers' capital position remained stable, with the ratio of capital to total assets standing at 11% for the life sector and 44.4% for the non-life segment as at the end of 2013. The non-life insurance

[8] Proceeds from underwriting activity are calculated by deducting expenses related to the business of underwriting such as claims paid, reserves carried forward, commissions and management expenses from the income received from underwriting business, which include premia written, reserves brought forward and other technical income.
[9] Net premia written are the premia written net of reinsurance.
[10] Single premium business refers to policies paid through a single premium payment at the beginning of the term, rather than premia paid over a longer period of time.
[11] The combined ratio is defined as the sum of net claims incurred and the net operating expenses over/as a proportion of the net earned premia. A combined ratio less than 100% signals underwriting profit, as insurers are taking in more in premia than paying out in claims and other expenses.
[12] Source: ESRB Risk Dashboard, February 2014.
[13] Source: ESRB Risk Dashboard, February 2014.
[14] 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 ceded out to re-insurers.
[15] Source: ESRB Risk Dashboard, February 2014.

sector remains characterised by higher capital levels, as is necessary, given that their business is generally associated with higher risks. Technical reserves, set aside by the whole insurance sector to cover future claims increased by 7.9% on a year earlier.

The recently published 2013 edition of the *World Risk Report* named Malta, once again, as the world's second safest country in terms of its exposure to and ability to cope with natural disasters.[16] Indeed, the domestic insurance sector views the risk of huge claims resulting from catastrophic events as remaining low. Moreover, to further limit the risk, while such events could be specifically covered, claims arising from such catastrophic events are also generally mitigated through the application of clearly stated exclusion clauses. Consequently, financial stability implications for the insurance sector are deemed remote.

5.2.2 Domestic investment funds

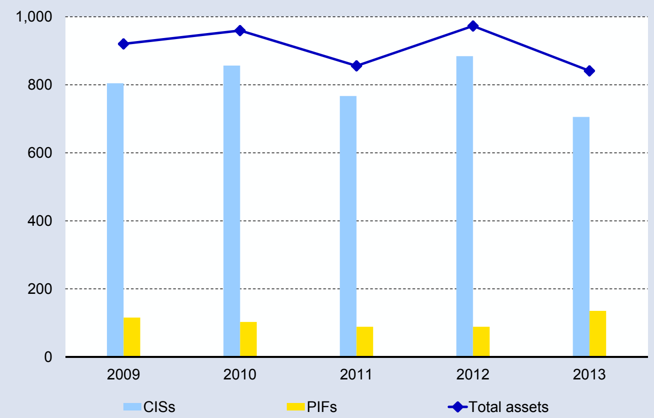
As at the end of 2013, there were 89 Collective Investment Scheme (CIS) sub-funds licensed by the MFSA, of which 29 are considered as domestic CIS, given that the majority of their shareholder units are held by residents.[17] Moreover, there were 509 licensed Professional Investor Fund (PIF) sub-funds, of which seven are defined as forming the domestic investment funds sector.[18] This section analyses developments relating to domestic CIS and PIFs. In terms of total assets, 60.1% of domestic investment funds are bond funds, whilst the rest are mainly equity funds.

The total asset value of the domestic investment funds sector (domestic CIS and PIFs) dropped by 13.6% during 2013, wholly due to CIS (see Chart 5.16). The contraction was mainly structural in nature, due to the closure of a sub-fund. On the other hand, PIFs grew by 52.5% during the year following the inception of two new funds. Total assets of CIS ended the year at €705.6 million, whilst PIFs' total assets amounted to €135.4 million. These funds' total assets amounted to 5.6% of core domestic banks' total assets as at end-December 2013.

The asset structure of CIS remained mainly in the form of Malta Government Stock (MGS) holdings, rising from 40.8% of investment assets in 2012 to 51.1% at the end of 2013 (see Chart 5.17). In contrast, only 1.9% of PIFs' investment assets were in the form of MGS in 2013. Holdings of sovereign euro area bonds (excluding Maltese sovereign debt) were limited to 1.3% of the portfolio for CIS, whereas PIFs did not have any holdings of this nature.

PIFs continued to predominantly invest in domestic and foreign equities, at 52% and 45.2% of investment assets, respectively. The bulk of these domestic equity holdings

Chart 5.16
TOTAL ASSETS OF THE INVESTMENT FUNDS SECTOR
(EUR millions)



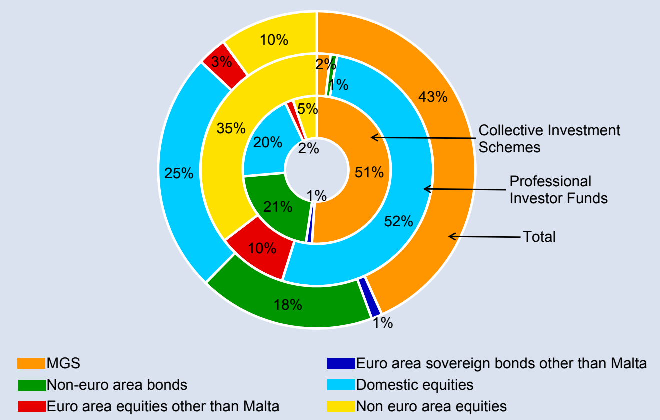
Source: Central Bank of Malta.

[16] The *World Risk Report* 2013 is drawn up by the United Nations University's Institute for Environment and Human Security in Bonn and Alliance Development Works, a coalition of German NGOs.
[17] Not all licensed sub-funds report data to the Central Bank of Malta.
[18] The Investment Services Act (1994) specifies that CIS are organisations with the aim of collectively investing "capital acquired by means of an offer of units for subscription, sale or exchange". PIFs are a special class of CIS, attracting persons or companies with a relatively higher initial level of capital.

was in the form of bank equity, highlighting the strong interconnectedness between the investment funds sector and the banking system. Domestic equity holdings of CIS amounted to almost 20% of their portfolio, almost equally made up of both bank and non-bank equities. Foreign equity holdings held by CIS only made up 7% of their investment portfolio.

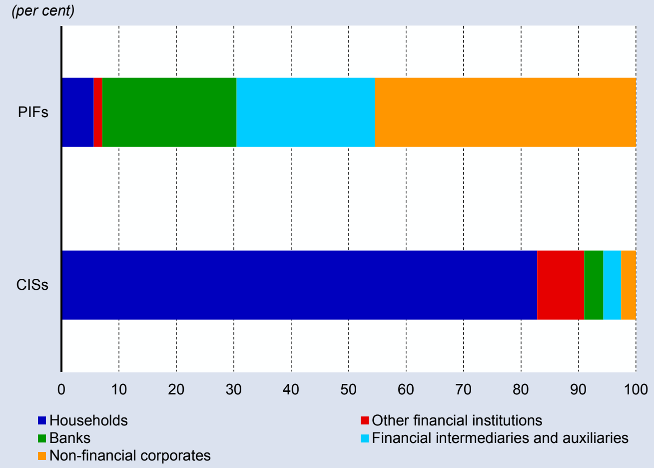
Core domestic banks continued to manage almost all of the domestic investment funds' net asset value. Nonetheless, the systemic relevance of the domestic investment funds sector remained limited, particularly as CIS holdings accounted for only 3.3% of household net financial wealth as at the end of the year, despite households being the major fund holders. Indeed, households held 82.8% of shareholder units in CIS at the end of 2013 (see Chart 5.18). On the other hand, since PIFs attract investors with a higher initial level of investment, households held only 5.6% of their shareholder units, a level which constitutes a small amount of household financial wealth. PIF's shares are mainly held by non-financial corporations (45.4%), financial intermediaries & auxiliaries (24.1%) and banks (23.4%).

Chart 5.17
ASSET ALLOCATION OF THE INVESTMENT FUNDS SECTOR
(per cent)



Source: Central Bank of Malta.

Chart 5.18
HOLDINGS IN INVESTMENT FUNDS
(per cent)



Source: Central Bank of Malta.

6. RISK OUTLOOK AND RECOMMENDATIONS

In 2013 economic growth in Malta was significantly stronger than in 2012, and outpaced most other euro area Member States. This positive trend is projected to continue in 2014. Thus, the expected pick-up in economic activity in Malta's main trading partners, as well as domestic economic policies, will continue to be supportive of financial stability as these are expected to continue to boost growth and employment. Developments in regulatory measures targeting credit risk, which were introduced and implemented in 2013, together with the voluntary increase in provisioning levels and the strengthening of capital levels by banks, will contribute to reinforce the resilience of the banking system.

BOX 6: MACRO-PRUDENTIAL POLICY

The financial crisis generated renewed interest in strengthening the need for macro-prudential oversight to mitigate and prevent systemic risk in the financial system. In this regard, European and international bodies have put in a lot of effort in strengthening the macro-prudential policy framework.

EU legislation defines systemic risk as the risk of disruption in the financial system with the potential of having serious negative consequences for the internal market and the real economy.[1] This risk can be decomposed into two main elements, structural and cyclical systemic risk. The structural element of systemic risk represents a level of risk that is inherent, irrespective of the macro-conditions within the financial system, such as excessive interbank interconnectedness. On the other hand, the cyclical element of systemic risk builds up during buoyant financial system conditions, manifested for example in excessive credit growth. Macro-prudential policy aims to mitigate both forms of systemic risk, through the application of tools/instruments. Hence, while the objective of micro-prudential policy is to limit the risk of episodes of financial distress in individual institutions, the objective of a macro-policy is to limit the risk of episodes of financial distress on the whole financial system and on the real economy.

Macro-prudential mandate

The European Systemic Risk Board (ESRB) is the European body responsible for the macro-prudential oversight of the financial system within the Union, thus contributing to the smooth functioning of the internal market and thereby ensuring a sustainable contribution of the financial sector to economic growth. In this regard, the ESRB has put forward a number of recommendations regarding the creation of a sound macro-prudential framework in individual Member States and within the European Union as a whole. By way of Recommendation of 22 December 2011 on the macro-prudential mandate of national authorities (ESRB/2011/3), macro-prudential authorities have been or are in the process of being set up in most EU countries.[2] As a follow-up to the ESRB Recommendation on the macro-prudential mandate of national authorities, the ESRB has published a report in June 2014 that assesses the overall compliance of Member States with the said Recommendation. The result of the assessment by the ESRB was very positive since a high level of adherence to the Recommendation was reported, as most counties, including Malta, either obtained a "fully compliant" or a "largely compliant" rating.[3]

In view of the above mentioned Recommendation, the domestic macro-prudential mandate was strengthened through the establishment of the JFSB. The JFSB was initially established in January 2013 on the basis of a Memorandum of Understanding between the Bank and the MFSA. The JFSB was given legal status by virtue of amendments to the Central Bank of Malta Act (Cap. 204) in November 2013. The Board is made up of representatives from the Central Bank of Malta, the

[1] Refer to Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board.
[2] http://www.esrb.europa.eu/pub/pdf/recommendations/2011/ESRB_2011_3.en.pdf?6466583db30e6efe3cd06753649e5eba
[3] http://www.esrb.europa.eu/pub/pdf/recommendations/2014/ESRB_2014.en.pdf?80f3dffb228cd0cac52d87cfb44a619e

MFSA, and the Ministry for Finance, the latter as observer.[4] The main objective of the JFSB is to establish mechanisms of cooperation between domestic authorities in matters impacting on financial stability. Furthermore, the JFSB shall be consulted on issues relating to the formulation of macro-prudential policy and the identification and assessment of macro-prudential instruments, together with, when relevant, micro-prudential instruments. The JFSB focuses on strengthening the resilience of the financial system and reducing the build-up of systemic risks, thereby promoting the contribution of the financial sector to economic growth.

Instruments for macro-prudential policy

The recommendation of 4 April 2013 on intermediate objectives and instruments of macro-prudential policy (ESRB/2013/1) was issued by the ESRB to operationalise macro-prudential policy through the selection of effective and efficient macro-prudential policy instruments in individual Member States to achieve financial stability.[5]

This Recommendation notes that to reach the ultimate objective of macro-prudential policy, i.e. financial stability and systemic risk mitigation, intermediate objectives need to be pursued. The ESRB puts forward five intermediate objectives that macro-prudential authorities are recommended to pursue. These include the mitigation of excessive credit growth and leverage, the prevention of excessive maturity mismatch and market illiquidity, limiting direct and indirect exposure concentrations, limiting misaligned incentives and moral hazard, and strengthening the resilience of financial infrastructures. The ESRB also provides an indicative list of macro-prudential instruments that enable the relevant competent authorities to attain such intermediate objectives.

Furthermore, the CRD IV/CRR Framework provides Member States with a legal framework establishing a set of macro-prudential policy instruments specifically introduced to target systemic risks, as well as a number of macro-prudential add-ons, which are essentially macro-prudential instruments constructed through an extension and/or modification of already established micro-prudential measures.[6] Given that the difference between macro-prudential and micro-prudential policy is the ultimate objective they seek to attain, a micro-prudential instrument can be adjusted to mitigate systemic risk.

Within the domestic framework, the macro-prudential policy framework is enhanced through Directive no 11 of the Central Bank of Malta Act, which lays out the objectives and implementation modalities of macro-prudential policy and instruments. Further to this, Legal Notice 29 of 2014 (Appointment of Designate Authority to implement Macro-Prudential Instruments) assigns to the Bank and the MFSA their respective responsibilities for individual macro-prudential instruments in the CRD IV/CRR Framework. Specifically, the Central Bank of Malta is entrusted with the implementation of the countercyclical capital buffer and the systemic risk buffer, as well as the macro-prudential add-ons introduced in CRR Article 458. Together with the MFSA, the Bank is also responsible for establishing a buffer on significant institutions, when applicable. Apart from such responsibilities, the Bank may also implement other macro-prudential instruments not featured in the CRD IV/CRR Framework.

At this juncture, the Central Bank of Malta is conducting research on a number of potential macro-prudential instruments and their relevance to reaching the intermediate objectives identified by the ESRB to develop an initial macro-prudential toolkit for the domestic financial system, in consultation with the JFSB.

4 The JFSB is chaired by the Governor, or, in his absence, the Deputy Governor, and includes two other representatives of the Bank and two representatives of the MFSA.

5 http://www.esrb.europa.eu/pub/pdf/recommendations/2013/ESRB_2013_1.en.pdf?6d15ae03f8179e086a910f0f194ee36

6 The CRD IV package transposes, via a Regulation and a Directive, new global standards on bank capital (commonly known as the Basel III agreement) into the EU legal framework, effective from 1 January 2014.
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0001:0337:EN:PDF
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0338:0436:EN:PDF

Challenges outside the financial sector in Malta

World economic activity is expected to strengthen during 2014, with forecasts for the United Kingdom and the United States showing further consolidation in economic expansion, while the euro area is projected to return to growth following two years of contraction. Considering that the European Union is a major trading partner for Malta, this improvement is expected to generate positive spill over effects on the domestic economy. The improved sentiment in the international economic scenario will also be conducive to improving the soundness of the banking sector. Amid signs of economic recovery, financial market sentiment towards stressed euro area countries has also become increasingly positive and the risk stemming from renewed tensions in sovereign debt markets receded during the year and is expected to diminish further in 2014.

However, the global search for yield has resulted in a tightening of the corporate and sovereign spread. This has increased the risk of a sharp and disorderly unwinding of recent investment flows to the euro area, especially in stressed countries. Furthermore, the persistent low interest rate environment and fall in yields have reduced the income flow from securities of core domestic banks, which is expected to remain on a similar trend.

The Maltese economy continued to expand during 2013, with Malta reporting the second largest growth rate in the euro area. Risks posed by domestic macroeconomic conditions have thus receded during 2013, and are expected to remain stable in 2014. This augurs well for the sustainability of public finances, which in turn, decreases the risk of any feedback loops between the public sector and the banking system. The exposure of financial institutions to Maltese sovereign debt is considered to pose minimal risk to the financial system, and is expected to remain stable. Improved domestic economic conditions, coupled with the Government's budgetary measures aimed at restoring stability in the demand for property, are expected to gradually bring a favourable impact on credit risk. Looking ahead, close adherence to fiscal targets by the Government, combined with the implementation of measures that boost investment, remain important conditions for the stability of the domestic financial sector.

Challenges within the financial sector in Malta

The overall resilience of the banking system improved during the year as it was supported by the pick-up in economic activity and sound macroeconomic policies. Nevertheless, domestic banks continued to face challenges, including those relating to the introduction of new regulatory requirements and the run-up towards the implementation of the SSM in November 2014, when the ECB will directly supervise three banks in Malta identified as "significant" according to established criteria.[1] During 2014 these "significant" banks will undergo an asset quality review (AQR) and a Stress Test and thus will be faced with closer scrutiny of their balance sheets. Such banks will carry a greater reporting burden in view of the ongoing preparations for the introduction of the SSM. Furthermore, the introduction of more stringent requirements of the new CRD IV/CRR Framework as of 2014, including the COREP and FINREP reporting to the EBA, will create further regulatory challenges for banks.

Rising non-performing loans (NPL) remained a key challenge for core domestic banks, particularly for loans extended to some segments of the corporate sector, namely construction. Apart from internal policy measures taken in previous years by banks to reduce their exposures to certain sectors and higher specific provisions during the year, this risk was further mitigated with the implementation of the revised Banking Rule BR/09 towards the end of 2013. The revised Rule requires banks to create a specific general reserve from distributable profits to be retained as capital. By the end of the implementation period of Banking Rule BR/09 in 2016, the coverage ratio should improve by about 3 percentage points.[2] This measure is intended to supplement current loan loss provisions incurred for impaired facilities under IFRS. Moreover, the Rule aligns the definition of NPL and forbearance with the newly established EBA draft Technical Standard on Supervisory Reporting on Forbearance and Non-Performing Exposures. Another aim of the Rule is for

[1] The criteria on which a bank is classified as significant include the importance of the institution for the economy of the country in which it is located or of the European Union as a whole and the total value of assets. These banks currently include Bank of Valletta plc, HSBC Bank Malta plc and Deutsche Bank (Malta) Limited.

[2] The "BR/09/2013 Measures Addressing Credit Risks Arising from the Assessment of the Quality of Asset Portfolios of Credit Institutions Authorised under the Banking Act 1994" increased the coverage ratio by 1.1 percentage points by the end of 2013.

credit institutions to recognise incurred losses as early as possible within the context of the IFRS. To this effect it also requires institutions to set up appropriate governance structures, a robust credit risk management framework and reporting systems. Furthermore, the Banking Rule BR/12 was also amended towards the end of 2013 in view of the idiosyncratic risks arising from credit institutions' concentration in the real estate sector.[3] This Rule requires banks to regularly and adequately assess risks related to the sector and take all necessary measures to mitigate such risks. These measures could include the establishment of sectoral limits.

During 2013 the banks continued to report subdued credit growth, particularly in the commercial sector in which credit contracted, contrasting with mortgage lending which continued to increase. Weak credit growth also impinged on the banks' profitability during 2013. This trend is expected to continue during 2014. The prolonged low interest rate environment could also raise the level of risk in the investment portfolios of institutions, in an effort to search for greater yield to limit as much as possible the downward pressure on profitability.

Short-term deposits have been a consistently large component of core domestic banks' liabilities. This has been a stable feature throughout various economic cycles and, consequently, banks are not likely to face significant challenges in meeting the new liquidity requirements under the CRD IV.

In line with the new capital requirements framework, which set higher minimum capital thresholds, banks will also be required to keep strengthening their capital base from external or internal sources. This entails that banks continue to adopt prudent dividend policies.

Risks to the financial system that may arise from non-core and international banks are anticipated to remain low, as activity by these banks continue to mainly involve non-residents, with very limited links to the domestic economy. While such banks could potentially only have a significant impact in terms of reputational risk for Malta as a financial sector jurisdiction, such institutions nevertheless remain well capitalised and liquid. The systemic relevance of the insurance and investment fund sectors also remained low. During the year, no new systemic risks have been identified from these institutions.

Table 6.1 summarises the main policy recommendations. Such measures are being considered or gradually implemented by the respective authorities and by the industry itself, which should enable banks to remain resilient in the face of a challenging, albeit gradually recovering, external environment.

Table 6.1
MEASURES TO ADDRESS KEY RISKS IN THE FINANCIAL SYSTEM

Risks	Measures required	Time horizon
Credit risk[1]	Full implementation of BR/09	*Short to medium term*
	Improve coverage ratio	*Short term*
Concentration risk	Allocation of capital under BR/12	*Medium term*
Capital Requirements[2]	Maintain prudent dividend policies	*Short term*

[1] To note that the significant banks will undertake an ECB AQR during 2014.
[2] To note that the significant banks will undertake an ECB/EBA Stress Tests during 2014.

[3] Banking Rule BR/12 "The Supervisory Review Process of Credit Institutions authorised under The Banking Act 1994", Annex 2G, Section F.

APPENDIX AND GLOSSARY

APPENDIX: FINANCIAL SOUNDNESS INDICATORS

COMPARATIVE INDICATORS 2009 - 2013 - (ALL FIGURES IN %)

	Core domestic banks				Non-core domestic banks				International banks				Total banks			
	2010	2011	2012	2013	2010	2011	2012	2013	2010	2011	2012	2013	2010	2011	2012	2013
Core FSIs																
Regulatory capital to risk weighted assets	12.89	13.53	14.14	14.94	29.77	29.08	28.86	24.16	104.70	115.53	115.63	118.43	54.64	56.78	55.82	46.11
Regulatory Tier 1 capital to risk-weighted assets	9.17	9.55	10.17	11.06	27.93	27.35	25.72	22.91	103.12	114.38	115.09	118.42	52.06	54.22	53.30	43.81
Non-performing loans net of provisions to capital	55.86	54.45	57.03	59.45	9.81	8.92	7.63	7.74	0.43	0.08	0.25	0.81	6.92	6.76	10.28	11.64
Non-performing loans to total gross loans	7.45	7.33	8.20	9.16	3.59	4.47	4.07	4.75	0.61	0.45	0.49	0.52	3.04	3.25	3.78	5.55
Sectoral distribution of loans to total loans																
Agriculture	0.31	0.30	0.29	0.30	0.06	0.07	0.07	0.06	0.00	0.00	0.00	0.00	0.11	0.11	0.12	0.16
Fishing	0.13	0.12	0.12	0.14	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.04	0.04	0.05	0.07
Mining and quarrying	0.10	0.08	0.08	0.05	0.07	0.01	0.01	0.01	0.00	0.00	0.00	0.00	0.04	0.03	0.03	0.03
Manufacturing	3.48	3.30	3.86	3.42	0.29	0.34	0.36	0.35	0.00	0.00	0.00	0.00	1.13	1.21	1.52	1.75
Electricity, gas, steam and air conditioning supply	5.50	5.70	2.50	2.37	0.09	0.10	0.11	1.39	0.00	0.00	0.00	0.00	1.76	2.06	0.97	1.34
Water Supply; Sewerage waste management and remediation activities	0.78	0.76	0.79	0.77	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.27	0.30	0.38
Construction	12.92	12.09	11.17	10.43	3.96	4.57	4.17	0.41	0.00	0.00	0.00	0.00	4.46	4.72	4.67	5.25
Wholesale and retail trade; repair of motor vehicles and motor cycles	10.19	9.91	9.40	9.06	0.64	1.22	1.79	0.63	0.00	0.00	0.00	0.00	3.30	3.67	3.79	4.59
Transportation and storage	4.60	4.63	4.36	4.07	1.05	1.08	0.95	0.80	0.04	0.05	0.00	0.00	1.58	1.78	1.77	2.12
Accomodation and food service activities	5.54	5.50	5.50	5.41	0.23	0.10	0.12	0.10	0.00	0.00	0.00	0.00	1.79	1.99	2.14	2.72
Information and communication	1.45	1.37	1.33	1.35	0.04	0.06	0.09	0.07	0.00	0.00	0.00	0.00	0.47	0.50	0.52	0.68
Financial and insurance activities	2.21	2.12	5.00	4.58	0.19	0.39	0.23	0.60	0.00	0.00	0.00	0.02	0.72	0.80	1.96	2.36
Real estate activities [includes inputed rents of owner-occupied dwellings]	4.17	4.05	4.03	4.48	2.80	3.13	3.04	3.95	0.00	0.00	0.00	0.00	1.57	1.71	1.82	2.67
Professional, scientific and technical activities	0.85	1.05	0.69	0.51	0.05	0.06	0.04	0.04	0.00	0.00	0.00	0.00	0.28	0.38	0.27	0.26
Administrative and support service activities	1.11	1.13	1.08	1.03	0.46	0.52	0.51	0.51	0.00	0.01	0.01	0.01	0.39	0.45	0.46	0.57
Public administration and defence; compulsory social security	1.49	1.47	1.49	1.60	0.00	0.00	0.01	0.00	0.00	0.00	0.00	0.00	0.47	0.53	0.58	0.80
Education	0.31	0.41	0.43	0.41	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.10	0.15	0.17	0.21
Human health and social work activities	0.47	0.54	0.64	0.66	0.00	0.28	0.27	0.25	0.00	0.00	0.00	0.00	0.15	0.22	0.27	0.36
Arts, entertainment and recreation	0.48	0.51	0.73	0.75	0.34	0.36	0.32	0.24	0.00	0.00	0.00	0.00	0.18	0.21	0.31	0.40
Other services activities	0.34	0.36	0.38	0.41	0.02	0.03	0.03	0.03	0.00	0.00	0.00	0.00	0.11	0.13	0.15	0.21
Households and individuals (excl. sole proprietors)	41.94	42.95	44.38	46.39	0.67	0.75	0.81	0.70	0.00	0.01	0.01	0.01	13.42	15.52	17.23	23.25
Mortgages	33.31	34.60	36.28	38.41	0.60	0.68	0.71	0.57	0.00	0.00	0.00	0.01	10.67	12.51	14.09	19.25
Activities of extraterritorial organisations and bodies	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Non-resident	1.63	1.65	1.75	1.82	89.02	86.94	87.09	89.84	99.95	99.94	99.98	99.97	67.69	63.51	60.90	49.83
Return on assets	1.40	1.32	1.63	1.45	1.33	0.49	1.41	0.96	1.10	1.20	1.26	0.81	1.20	1.16	1.37	1.00
Return on equity	22.38	19.46	23.90	19.94	4.35	1.37	6.47	5.84	3.08	3.90	3.62	2.66	5.00	5.09	5.91	5.02
Interest margin to gross income	70.66	72.46	66.80	65.29	63.39	69.96	28.93	52.87	62.05	89.00	124.34	176.78	66.01	79.11	83.14	100.37
Non-interest expenses to gross income	49.66	54.07	45.54	48.01	35.45	45.53	28.36	41.10	8.18	8.87	7.06	10.29	30.02	34.10	27.38	34.43
Non-interest income to gross income	29.34	27.54	33.20	34.71	36.61	30.04	71.07	47.13	37.95	11.00	-24.34	-76.78	33.99	20.89	16.86	-0.37
Liquid assets to total assets	24.93	24.09	28.81	29.44	10.86	14.74	14.40	16.28	5.76	7.39	9.90	28.16	15.09	16.11	19.64	26.79
Liquid assets to short-term liabilities	42.85	44.10	49.07	48.93	82.86	90.40	82.44	94.61	86.15	111.02	146.25	401.40	47.83	49.59	55.61	59.46
Other FSIs																
Coverage ratio	34.29	35.57	37.59	39.48	43.80	54.35	59.74	42.40	76.03	107.67	95.15	52.17	40.22	43.26	43.64	40.79
Domestic investment securities to total assets	12.28	12.76	11.95	12.10	2.23	2.23	2.88	4.29	0.00	0.00	0.00	0.00	3.55	3.77	3.59	4.10
Foreign investment securities to total assets	11.90	11.46	10.73	11.85	35.13	36.10	38.25	39.19	28.75	31.50	36.50	38.28	24.81	26.37	29.55	30.41
Unsecured loans to total lending	20.02	19.79	19.54	21.83	54.69	39.48	50.73	61.53	30.83	54.24	57.82	61.92	29.44	40.64	42.42	41.86
Assets to total capital and reserves (*)	15.78	15.48	14.54	13.83	4.12	4.21	4.90	5.01	1.60	1.56	1.45	1.33	3.13	3.13	3.14	3.65
Large exposure to capital	144.86	138.48	123.12	136.13	72.86	131.21	111.74	108.84	6.43	10.17	10.87	17.33	25.45	32.03	31.40	46.52
Gross asset position in financial derivatives to capital	2.18	4.89	3.20	2.13	0.68	1.51	0.55	1.34	0.48	0.41	0.54	0.01	0.68	0.98	0.86	0.50
Gross liability position in financial derivatives to capital	7.88	11.56	10.76	5.54	1.06	2.45	2.68	0.76	0.10	0.12	0.07	0.12	0.99	1.54	1.53	1.12
Personnel expenses to non-interest expenses	55.61	52.44	53.92	51.22	34.52	36.24	39.56	43.88	19.41	21.24	26.26	33.80	48.09	46.50	48.56	48.15
Customer deposits to customer loans	141.74	137.51	142.71	150.46	38.16	55.70	68.82	88.39	81.94	71.93	76.09	139.60	102.58	99.78	106.59	139.78
Net open position in equities to capital	16.07	17.74	17.36	17.41	80.38	79.71	75.95	80.66	0.89	0.89	0.27	0.02	7.49	7.68	7.65	10.60
Net open position in foreign exchange to capital	-2.64	-0.13	0.03	0.56	0.78	-1.80	0.83	-1.15	-0.40	0.03	-1.21	-0.30	-0.28	-0.10	-0.91	-0.23
Loan to value:(**)																
Residential	72.54	73.48	70.38	73.62												
Commercial	62.43	63.16	63.19	63.11												

(*) expressed as a ratio.
(**) Based on a sample of 4 domestic banks, updated 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.

Bilateral liquidity/currency swap arrangement: a type of currency swap used by a national central bank to provide liquidity of its currency to another national central bank.

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 to net earned premia. A combined ratio less than 100% signals underwriting profit.

Composite Indicator of Systemic Stress (CISS): an indicator composed of 15 financial stress measures split equally in five categories, including the financial intermediaries sector, money markets, equity markets, bond markets and foreign exchange markets.

Core Tier 1 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 NPLs.

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.

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

Depositor Compensation Scheme: a rescue fund for depositors of failed banks which are licensed by the Malta Financial Services Authority.

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.

Emerging markets: countries defined as per the list of emerging markets and developing countries specified by the IMF, FTSE, MSCI, the Economist, S&P, Dow Jones, BBVA and Columbia University EMGB.

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

Fixed rate tender procedure: a tender procedure in which the interest rate is specified in advance by the central bank and in which participating counterparties bid the amount of money they want to transact at the pre-set interest rate.

Harmonised Competitiveness Indicator (HCI): 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.

Index of Industrial Production: an index describing the economic cycles of the manufacturing industry.

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 an impact on the estimated future cash flows from the loan that can be reliably estimated.

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.

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. It will be introduced in 2015, but fully implemented in 2019. The ratio is defined as the stock of HQLA over the total net cash outflows over the next 30 calendar days, which must exceed 100%.

Liquidity ratio: the value of liquid assets to short-term liabilities. In terms of Banking Rule BR/05/2007 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 bank's 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.

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.

Special-term refinancing operations: a liquidity-providing operation by the euro system against eligible collateral for the duration of a maintenance period.

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 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.

Net interest income: the difference between the revenue/interest generated from a bank's assets and the expenses/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: annual net income before tax divided by a 12-month average value of total assets.

Return on equity: annual net income before 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 are withdrawable 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.

Switch Auction Programme: a voluntary programme launched by the Maltese Government in 2011 to convert MGS maturing between 2012 and 2014 into securities with longer maturities.

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

Tier 1 capital ratio: Tier 1 capital expressed as a percentage of risk-weighted assets.

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

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.